AN INQUIRY INTO THE CONCEPT OF PUBLIC INTEREST AND ITS RELEVANCE TO ACCOUNTING THEORY AND PRACTICE

By

ABRAHAM PETRUS JACOBUS IMMELMAN

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To my wife Ina, and my children,

Abrie
Marianne
Pieter
Danie
Elmarie

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Abraham Petrus Jacobus Immelman

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Chairman: S. C. Yu
Department: Accounting

The frequency with which the words "public interest" appear in the accounting literature suggests that the concept of public interest may be relevant to accounting theory and practice. The aim of this study is to determine whether the concept is relevant to accounting and to consider some implications of the outcome of the inquiry for accounting theory and practice. To this end, an inquiry into the meaning of "the public interest" and into the functions of accounting is undertaken.

Since accounting is a measurement discipline, it is necessary to find operational definitions for concepts to be related to accounting. Although no consensus exists about the constitutive meaning of the concept of public interest, it is widely accepted as a commendatory concept used in justifying social behavior and in selecting and justifying public policy. A nonarbitrary descriptive meaning can be determined for it in particular cases by relating the anticipated effects of social behavior or public policies to established community values. On the presumption that government is a trusteeship, all of whose activities are properly

directed to the benefit of the public, public policies formulated by governmental officials may be regarded as operational definitions of the public interest. Two of the cornerstones of the American economy are a private enterprise system to undertake the production of goods and services, and a market mechanism to distribute the output produced and to regulate the supply of factors of production. Thus, governmental policies to enhance the working of the market mechanism and to promote private enterprise provide relevant operational definitions of the public interest for the purpose of the inquiry.

A market equilibrium model, based on the conditions for achieving a Pareto welfare optimum in the production of goods and services illustrates that accounting information, when used in market operations, may affect the efficient functioning of the market. The functions of accounting, as an information system in the promotion of private enterprise, are to serve as a planning and control tool in the hands of business management and to enhance harmonious cooperation among organizational participants. The efficiency achieved by accounting in the performance of these functions may have an impact on the functioning of the private enterprise system. On the basis of the potential of accounting to affect these two important institutions of the country's economic system, it may be inferred that the concept of public interest, as here defined, is relevant to accounting theory and practice.

The character of a number of generally accepted accounting principles and auditing standards, the contents of the code of professional ethics of the public accounting profession, and the frequency with the public interest is referred to in accounting literature, suggest that the public interest is an implicit environmental accounting postulate. This

view is strengthened by the present demonstration that the concept is relevant to accounting. Explicit recognition of the postulate accentuates the need to define it in order to ensure that the set of postulates maintains its internal consistency and harmonious relations.

Two tentative accounting-domain postulates illustrate some possible implications of the particular definition of the public interest adopted in this study. The "market postulate" describes the relevance of accounting information to the functioning of the market mechanism and the "behavioral postulate" states the relevance of accounting information to the functioning of the private enterprise system. These postulates, among others, underlie a "current replacement cost principle" and a "goal-accomplishment reporting principle," respectively. The explicit recognition of a public interest standard in the realm of public accounting practice may accentuate the importance of the independence standard, the auditor's core function as an impartial representative of each of the groups of organizational participants, and the public functions of the auditor as a representative of society.

CHAPTER 1

INTRODUCTION

Four leading professional organizations - the American Institute of Certified Public Accountants (AICPA), the Financial Analysts Federation, the Financial Executives Institute, and the Robert Morris Associates - sponsored a symposium held at the Seaview Country Club, Absecon, New Jersey in November, 1968. Professor John C. Burton of Columbia University, acting chairman, reports the proceedings at the symposium in the AICPA publication, Corporate Financial Reporting: Conflicts and Challenges. In a section entitled "The Role of the Auditor" an anonymous Certified Public Accountant (CPA) is reported to have said:

> It seems to me that what is at stake is really the free enterprise system, and what is involved is the public interest. All of us are involved with the public interest. The reason for having public accountants is the public interest. Managements have greater and greater responsibility to the public as evidenced by court cases and other public actions. I think it has become evident that their responsibility runs far beyond stockholders today to the general public. . . . If we ever hit a point - and we're all involved in this - where the public feels that corporate financial reporting is not sufficiently reliable and has sufficient integrity, then the whole free enterprise system is going to suffer. And if this happens, we are all going to suffer with it. . . . So I think we had better sit back occasionally and look at the overall thing, the total picture, and recognize that the public interest is going to be determined by what the public thinks, regardless of what we think (1, pp. 72-73).

This passage raises the question of whether the viewpoint expressed by this speaker is an isolated opinion or whether it is supported by other professional accountants and accounting scholars. At least one scholar,

James Wesley Deskins who also noticed this phenomenon wrote in 1965: "When reading the literature of accounting, one notices the frequency with which the words 'public interest' appear" (2, p. 76). Although Professor Deskins did not substantiate his assertion, the alert reader finds that his observation is correct. The following quotations from the accounting literature constitute but a small random sample from a large number of instances in which the public interest is referred to:

John L. Carey, a past president of the AICPA, states in Professional Ethics of Public Accounting:

> The rules of professional conduct of the accounting profession are in part a pledge to the public that in consideration of public confidence the profession will protect the public interest . . . (3, p. 2).

And in the 1966 revised edition of Carey's book, co-authored by William O. Doherty, the authors explain:

> A code of professional ethics is a voluntary assumption of self-discipline above and beyond the requirements of the law. It serves the highly practical purpose of notifying the public that the profession will protect the public interest (4, p. 3).

In his Contemporary Corporate Reporting and the Public, published in 1963, Professor Dwight R. Ladd discusses accounting and reporting principles with emphasis on the impact of corporate reporting on the public. According to him one of the functions of accounting is to facilitate the control of private business and

> . . . there is no doubt that both during the transition period to automated industry and after, control of business . . . is required by the public interest. . . . For purposes of these discussions, "the public interest" has been defined in terms of efficient and equitable use of resources the corporation controls (5, p. 10).

Allusion to the public interest in the accounting literature is not limited to the United States. Discussing the recommendations of the Commission of Enquiry into the South African Companies Act, Professor

M. L. Benade states that the commission

> . . . accepted that timeous disclosure of meaningful information about the current state of affairs of a company has, apart from the interests of investors and shareholders, become a matter of public interest as well (6, p. 442).

The following statement appears in a report by the Committee on External Reporting of the American Accounting Association (AAA). The report, entitled "Evaluation of External Accounting Practice," is published in the 1969 Supplement to the Accounting Review. The committee was charged to "survey present external accounting practices, to assess their merits in the light of the standards for accounting information suggested in the AAA Statement of Basic Accounting Theory [ASOBAT] and to suggest changes to bring practice into line with the standards" (7, p. 79). Under the heading "Social and Economic Constraints" the committee contends:

> Although not included in the ASOBAT four standards, we feel that a basic constraint in the selection of data to be included in accounting reports and in the method of presentation is the probable social and economic effects of disclosing certain types of information. The social interests may be served by permitting the withholding of relevant information in those cases where it would not be in the public interest to make full disclosure even though such withholding might make the reports biased or lacking in relevant data (7, pp. 95-96).

In other words, this committee ranks the public interest above two of the four standards* regarded as very important by the ASOBAT committee, viz., the standard of relevance, the "primary standard" (8, p. 7), and the standard of freedom from bias. This position taken by the committee on external reporting stimulates the desire to discover more about the place of the public interest in the realm of accounting. Also

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* Relevance, quantifiability, verifiability, and freedom from bias.

interesting is the committee's reference to "social and economic effects" and "social interests" because it provides some indication of the committee's conception of the public interest.

The reference by the committee on external reporting to the social effects of accounting information also draws attention to the frequency with which the words "social" and "society" appear in accounting literature. In A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements issued in 1936, the Executive Committee of the AAA points out that on the interpretation of the published financial statements of corporations

> . . . depend so many vital decisions of business and government that they have come to be of great economic and social significance (9, p. 1).

Three years later the Committee on Accounting Procedure of the AICPA published Accounting Research Bulletin No. 1 in which it states:

> The Committee regards corporate accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole - not from that of any one group of interested parties (10, p. 1).

And in expounding the enterprise theory of accounting in "Accounting Theory and the Large Corporation," Professor Waino W. Suojanen wrote in 1954:

> Where the accountant once was concerned merely with assisting owners of a business to evaluate its operations in money terms, he now must recognize a broad social responsibility (11, p. 398).

Also Professor Norton M. Bedford, in an article, "A Communication Theory Approach to Accountancy," written in collaboration with Vahe Baladouni, indicates the social implications of accounting information in the

following words:

> But the criteria which the accountant should use to reveal messages that are significant have not been well set forth. If he reveals one type of information, certain logical consequences follow which are entirely different from the results which would ensue if other information was reported. The issue is much more involved for it has its basis in the purpose of society itself. By what they report, accountants call certain activities to the attention of society for evaluation, and by evaluating, society influences future activities (12, p. 656).

Other well-known accounting authors who contributed towards the viewpoint that accounting information produces public interest consequences or that accounting performs social functions include W. A. Paton (13), W. A. Paton and A. C. Littleton (14), Raymond J. Chambers (15), Reginald S. Gynther (16), Kenneth MacNeal (17), and Leonard Spacek (18, p. 222).

Therefore, the contention of the anonymous CPA cited by Professor Burton does not appear to be an isolated opinion. The relevance of social and public interest considerations to accounting is recognized by leading organizations of accounting practitioners and academicians as well as by individual accounting scholars in the United States and abroad. Notwithstanding this recognition, the social functions and public interest consequences of accounting have never been clearly defined. Some indication, however, of accounting thinking in this matter is provided by the following extracts from the literature:

In a 1940 AAA publication, <u>An Introduction to Corporate Accounting Standards</u>, W. A. Paton and A. C. Littleton explain:

> There is another way in which accounting is important from a social point of view. Capital should flow into those industries which serve the public interest, and within an industry into those enterprises in which the management is capable of using capital effectively . . . (14, p. 3).

A similar explanation is presented by Reginald S. Gynther in a 1967 article, "Accounting Concepts and Behavioral Hypotheses," where he states:

> In private enterprise economies, capital instruments are channelled into the various corporations and different industries by decisions based largely on accounting data. Therefore the optimum allocation of resources depends to a marked degree on the soundness of the results shown by this accounting data (16, p. 289).

Substantially the same explanation of the function of accounting in its social and economic environment is offered by R. J. Chambers in a paper presented at the University of Michigan in January, 1967. According to him

> . . . it is believed to be in the public interest that investors should be able to choose in an informed manner the firms in which they shall invest; and . . . it is believed that if informed investors act in their own interest they will distinguish the more efficient firms from the less efficient, support the former, and thereby promote the more efficient use of the community's resources (15, p. 273).

From the foregoing illustrations it can be concluded that a number of accounting writers as well as spokesmen for the accounting profession maintain that, in addition to the <u>private</u> function of serving as a management tool and a means of reporting on management's stewardship to owners, accounting performs a <u>public</u> function which may produce public interest consequences. The latter function, however, is not yet clearly defined or explicitly included as a generally accepted function of accounting.

Statement of the Problem and Purpose of the Study

It is important that the functions of accounting be clearly understood and defined for the purposes of formulating accounting theory and

guiding accounting practice. Asserting that accounting also has public functions and that the profession is obligated to recognize the public interest in the performance of its public functions, necessitates a better understanding of the concept of public interest. In addition to clarifying the concept, accountants also need to understand how their activities as manifested by the reports that they prepare or certify can affect the public interest. Thus, the problem can be stated in the form of a few questions:

1. How can "the public interest" be defined?
2. What are the functions of accounting in a given society?
3. Does accounting information affect the public interest as defined, and if so, how?
4. What are the implications of the answer to the previous question for accounting theory and practice?

The purpose of the present study is to seek answers to the questions posed above. Acceptable answers to the first three questions will, hopefully, shed some light on the question of whether or not the concept of public interest is relevant to accounting. Thereafter it will be possible to inquire how a conclusion of relevance (or irrelevance) might affect accounting theory formulation and accounting practice.

Methodology and Plan of Study

For the purpose of exploring the thesis that the concept of public interest is relevant to accounting, analytical tools and deductive reasoning are employed. However, accounting is not a pure subject; its "propositions are synthetic propositions which cannot be completely devoid of empirical contents" (19, p. 3). Thus, the inductive phase

of inquiry cannot be neglected. Material and evidence for this phase are taken from published studies and statistics.

The following hypothesis has been formulated to guide the inquiry:

If it can be demonstrated

1. that it is possible to define the concept of public interest operationally and
2. that accounting information may affect the public interest, so defined,

then it follows that the concept of public interest is relevant to accounting theory and practice.

The requirement that it must be possible to define public interest operationally is prescribed by the fact that accounting is a measurement discipline. Measurement implies the application of operational procedures to a problem concerning a concept to be quantified and the operational definition specifies the elements to be considered.

In order to determine whether the first condition contained in the hypothesis can be met, the public interest concept is examined in Chapters 2 and 3. An exploration of the acceptability of the concept in professional and academic circles is undertaken in Chapter 2 in order to provide a background for an inquiry into the meaning of the concept and to demonstrate the lack of general agreement, both with regard to the meaning of the concept and its usefulness to the social sciences. The possibility of obtaining reasonable agreement on a general meaning of the concept which can guide the formulation of operational definitions is explored in Chapter 3.

In order to determine whether the second condition contained in the hypothesis can be met, the function of accounting in a capitalistic

economy is examined in Chapters 4 and 5. The function of accounting at the macro level is considered in Chapter 4. The word "macro" is used to mean the total economic activity of producing and distributing economic goods and services in a given community. The efficiency achieved by the economic machinery at this level concerns all the consumers and producers of the community. If it should appear that accounting activity is a contributing factor towards the achievement of efficiency at the macro level, a prima facie case for admission of the thesis that accounting performs a public function exists. The public interest implications of such a conclusion depend on the selected definition of the public interest. Accounting also performs a function at the micro level by aiding the direction of the economic activity of individual firms. In Chapter 5 inquiry is directed at the question of whether or not the manner in which this function is performed may have public interest consequences in the light of the definition of the concept of public interest selected in Chapter 3.

The conclusions of Chapters 2 through 5 are synthesized in Chapter 6 in order to determine whether or not the thesis that the concept of public interest is relevant to accounting is valid. Some implications of the outcome of the inquiry for accounting theory and practice are considered in the rest of Chapter 6.

Constraints and Assumptions

Since the concepts and problems dealt with in this study are broad and not well defined, some constraints are necessary to keep the inquiry within manageable limits. The chosen social and economic environment is that of the United States at the present time, i.e., the early

nineteen seventies. It is assumed that no major changes will take place in the near future so that the analysis will be relevant to conditions pertaining for a reasonable future period. Certain analytical tools from the area of Welfare Economics are utilized in this study. The validity of that economic analysis under current circumstances is assumed. Although it is true that the theoretical analysis applies to conditions of perfect competition, the assumption of validity appears reasonable by virtue of the degree of competition that still characterizes the American economy. While economists are aware of the limitations of any model that assumes perfect competition, they still find it useful as a point of departure in discussions dealing with certain socio-economic relationships, provided that modifications to make it applicable to real world situations are considered in the final analysis.

CHAPTER 2

CURRENT ACCEPTABILITY OF THE PUBLIC INTEREST CONCEPT

The term "acceptability" in the heading of this chapter must be taken to mean the degree of acceptance in academic and professional circles of the concept in question as a social concept in its own right. If a status of "wide acceptance" is revealed, further inquiry into the meaning of the concept and its applicability or relevance to social relationships and activities seems justified. A "Study Group" consisting of seven accounting professors at the University of Illinois comments on concept formulation as follows:

> In general, concepts are formed primarily through observation and are established through agreement. Through repeated observations it is discovered that certain items have common characteristics not possessed by other items. . . . Concepts of intangible things are more difficult to develop as abstract ideas because direct observation is impossible; they are also more difficult to establish through agreement because differences of opinion cannot be settled by common observation (20, p. 12).

An example of a concept of intangible things is the public interest concept. Its subject-matter is highly abstract and, thus, it can be expected that agreement on the meaning and validity of the concept might be difficult to secure. This expectation is borne out by an examination of the relevant literature from which it appears that theorists and professionals can be classified into three groups. At one end of a spectrum are adherents of the view that the concept not only serves a useful practical purpose, but also can be defined meaningfully so as to

warrant its inclusion as a basic concept in the social disciplines. For convenience, the label "pro-school" may be used to refer to this group. At the opposite end of the scale are some prominent scholars of political science who reject the concept completely. For instance, Glendon A. Schubert, Professor of Political Science, states:

> I would also argue, in any event, that if the public interest concept makes no operational sense, notwithstanding the efforts of a generation of capable scholars, then political scientists might better spend their time nurturing concepts that offer greater promise of being useful tools in the scientific study of political responsibility (21, p. 176).

In the middle, a number of writers may perhaps be grouped into a "school," saying that the concept does merit attention, but with qualifications. Their reasons for acceptance of the concept, as well as their reservations, vary widely.

The unsettledness of the public interest controversy presents a dilemma to the accounting researcher who wishes to inquire whether or not the concept is relevant to the study of accounting. An easy escape route might be suggested: if the concept is as "vague," "imprecise," "mythical," and "non-operational" as knowledgeable scholars in the relevant disciplines assert then perhaps it would be advisable for accounting students to reject it forthwith in favor of concepts that offer greater promise of being useful tools in the study of accounting. But, is this escape route really available? Is the accounting scholar or, for that matter, any social scientist free to ignore a persisting ideology in the hope that "it will go away if we just ignore it," simply because it appears to defy unequivocal definition? The idea of the "common good," "general welfare," or the more modern "public interest" is as old as society itself; it intrigued philosophers both before and after

Aristotle and Plato, and it is invoked with and without justification to reinforce viewpoints and rationalize policies. For this reason, if for no other, a careful consideration of the concept is necessary before a firm decision to dismiss it from the social sciences can be justified. Such an examination is undertaken in the following pages. The arguments of the rejectionists are inspected first. While the rejectionists due to their definitely negative views are relatively easy to distinguish from the rest, those who find some merit in the concept are hard to categorize into schools on the basis of the degree of acceptance they reveal. For this reason, the middle-group and pro-school are treated under one heading.

The Rejectionists

The views of the political scientists Frank J. Sorauf and Glendon A. Schubert may be regarded as representative of this group. The gist of a 1957 article by Sorauf (22, p. 616) is neatly summarized by Leys and Perry, as follows:

> He makes it clear that the citizens and officials are not merely in disagreement over the methods of securing the public interest; they disagree on the meaning of the words, as follows:
>
> 1. The Public Interest as Commonly-Held Interests or Values.
>
>   EXAMPLE: "It (a decision) is said to be in the public interest if it serves the ends of the whole public rather than those of some sector of the public." Meyerson and Banfield, Politics, Planning and Public Interest, p. 322, Free Press, 1955.
>
> 2. The Public Interest as the Wise or Superior Interest.
>
>   EXAMPLES are found in discussions of the conservation of natural resources, the control of traffic in alcoholic beverages, in slum clearance, and the construction of new schools; often in judgments concerning the protection of consumer interests.

3. The Public Interest as Moral Imperative.

   EXAMPLE: "The public interest is what men would choose if they saw clearly, thought rationally, acted disinterestedly and benevolently." Walter Lippmann, The Public Philosophy, p. 42, Little Brown, 1955.

4. The Public Interest as a Balance of Interests.

   EXAMPLE: "The public good rarely consists in yielding completely to the demands of one class or group in society. It more often consists in the elaboration of compromise between conflicting groups." V.O. Key, Politics, Parties and Pressure Groups, p. 174, 1953.

5. The Public Interest Undefined.

   EXAMPLE: R. MacIver's The Web of Government, pp. 197, 416 (N.Y., 1947). Sorauf takes the phrase here to refer to vague values, broad enough to elicit widespread agreement, but too wide to be relevant to the struggle for policy influence. The public interest is a symbol whose purpose is to give the appearance of unity rather than to settle political conflict.

Sorauf associates the popularity of "the public interest" with American middle class attachment to the values of moderation, to their distaste for political struggle, and to a misconception of group antagonisms in a period when American life is producing an increasing diversification of interests. The best that can be said for "public interest," he thinks, is that it symbolizes the process of group accommodation. It may serve a "hair shirt" function. But Sorauf regards "the public interest" as useless as an instrument for political analysis (23, pp. 7-8).

In an article entitled "The Conceptual Muddle," published in 1962, Sorauf takes "an even stronger and more negative position" (24, pp. 183-190). His main thesis here is that the concept is vague, imprecise, and a myth, and

> whereas imprecision, vagueness and mythology may serve some strategic purpose in the world of affairs, they contribute nothing to the formulation of valuable generalizations and theories about politics and the evolution of public policy (24, p. 190).

His views, leading to the above conclusion, can be summarized as follows: The public interest, as a fictional device for the ordering of human affairs, is a "potent political myth, and as with any myth, its value rests in not defining it, in not drawing it out from the shrouds of mystery" (24, p. 185). No scholarly consensus exists on the public interest, neither as to its definition, nor "about what they are trying to define: a goal, a process, or a myth" (24, p. 185). The normative and the real, the "ought" and the "is" are confused:

> In much of contemporary usage public interest means an interest possessed by (and, presumably, at least dimly perceived by) "the public" or some segment of it; in this sense it is a real, empirically identifiable interest. And at the same time it refers to a goal in the interest (i.e., "best interest" or "enlightened self-interest") of the public, whether or not that public is or is not sufficiently enlightened to grasp it. So the "is" and the "ought" are inextricably knotted together in this single phrase, the public interest (24, p. 186).

The concept often serves little more than rationalization of particular interests, whereby it is attempted to erect personal goals into universals. No single criterion, such as the public interest, can subsume or encompass all that is good and desirable for society. One "glib phrase" cannot solve all the dilemmas of a political pluralism. Concepts which clarify competing interests and separate the "is" from the "ought" are needed. Apparently Sorauf does not believe in the possibility of the achievement of consensus on a constitutive definition of the public interest which will be capable of supporting operational derivatives for the guidance of public policy.

Glendon A. Schubert's investigation of the usages of the public interest concept to be found in the writings of political scientists during the three decades preceding 1961 is reported in his book, The Public Interest: A Critique of the Theory of a Political Concept,

published in 1961 (25). He divides theorists of the public interest into three groups: rationalists, idealists, and realists. The rationalists envisage a political system in which the norms are all given and the function of officials is to translate the given norms into specific rules of governmental action. The idealists conceive of the decision-making situation as requiring the excercise of authority in order to engage in social planning by clarifying a vague criterion. The realists state that the function of public officials is to engage in the political mediation of disputes; the goals of public policy are specific but in conflict.

Both the rationalists and the idealists include those who see some merit in a concept of public interest (the pro-school and middle-group). The main difference is that the rationalists view the common good as being expressed by the popular will whereas the idealists believe that the public interest reposes in a higher, natural law; there is no assurance that the public will is right. Policy-makers have also to consult the voice of conscience. The rejectionists would most probably prefer to associate with the realistic who are more concerned with a "due process-equilibrium theory." According to this theory each policy should receive full consideration of all relevant factors, including the interests of individuals or groups who may be affected by the decision. The realist does not claim that all decisions that are the product of a process of full consideration will always be the "right" decisions or that they will be "in the public interest." However, such a probability will be maximized by a policy of due process.

Schubert concludes that his categorization has utility for analytical purposes only. No matter how the literature is classified and the

data compared, no systematic body of public interest theory can be revealed. Operational definitions of the concept of public interest are required to guide officials who have to take public interest decisions and researchers who might wish to investigate empirically the extent to which governmental decisions are in the public interest. Neither his analysis nor that of contemporary students of the concept suggest that the concept is capable of being made operational. Although the concept serves, at times, a "hair shirt" function, in Sorauf's terminology, it neither adds to nor detracts from the theory and methods presently available for analyzing political behavior.

To summarize, a number of political scientists question the usefulness of the public interest concept on the grounds that no consensus can be reached in regard to a meaningful constitutive or operational definition capable of guiding political theory and policy. Consequently, they suggest that attempts at defining and incorporating it in their discipline be terminated and that attention be directed at alternative means to serve the purposes for which the concept is presently utilized.

The Pro-School and Middle-Group

The majority of social scientists do not completely reject the public interest concept and can be classified into one of the above two categories. The differences among them are, however, not simply a matter of degree but include fundamental issues that merit close consideration. A fruitful exercise might be an examination of the reasoning underlying the approval and reservations expressed by scholars from the relevant disciplines, i.e., Philosophy, Social Philosophy, Law, Political Science, and Economics.

Philosophers and Social Philosophers

Wayne A.R. Leys and Charner M. Perry indicate disapprovingly in Philosophy and the Public Interest that "as we read the philosophical literature of the past twenty years, we find . . . only a few . . . philosophers addressing themselves to the subject" of the public interest (23, p. 8). The philosophers who are quoted by lawmen and social scientists belong mainly to earlier generations; for instance; John Dewey, T.H. Green, the utilitarians, and others.

Leys seems to base his sympathy with the concept on an elaborate study undertaken earlier by himself and Perry involving a survey of the relevant literature and comments invited from seventy-five philosophers, lawyers, and other social scientists. This investigation led him to believe that "the problem of reaching consensus was not due to vagueness or a limitless variety of meanings"(26, p. 238). He reports that:

> After much pondering of uncongenial vocabularies, we were able to recognize one descriptive meaning and three normative meanings (26, pp. 238-239).

Leys states that contemporary philosophy does not give much support to their findings. Whereas Leys and Perry suggested that interdisciplinary discussions of the public interest would be enhanced "if a few general conceptions were defined" (26, p. 240), most of the recent philosophical writers have been very skeptical about the possibility of defining normative meanings generally. Nonetheless, founded on personal conviction and reinforced by the survey that he and Perry conducted, Leys feels justified in concluding that:

> . . . the rival claims of public interests in various activities do not demonstrate the folly or the impossibility of articulating those interests. Nor does the improbability of complete agreement on specific public policies disprove the possibility of general criteria

> or standards, which are properly called "the public interest." On the basis of the survey which Perry and I made, I should say that there are three meanings which can reasonably be attributed to "the public interest" as a set of criteria for judging proposed governmental actions. Ideally, governmental action will
>
> 1. maximize interest satisfactions (utility),
>
> 2. be determined by due process,
>
> 3. be motivated by a desire to avoid destructive social conflict (good faith) (26, p. 256).

He agrees with the skeptics that "no one can formulate an abstract principle called 'the public interest' which all intelligent men would be willing to apply deductively to policy decisions" (26, p. 255); that in the end there is a "leap of faith, a commitment, an engagement" (26, p. 256), but he maintains that "this predicament does not justify some of the recent philosophical contentions that a wise man will not try to define what he means by 'the public interest' and that policy discussions are rendered more confused and futile by sharply defined general standards" (26, p. 256).

Brian M. Barry, a social philosopher, approaches the problem by examining the words "public" and "interest." Then he defines "common interest" and proceeds to distinguish between "policies" and "particular acts." Finally he suggests a "higher-level policy" as representing the public interest. For a definition of "public" he quotes Sir George Cornewall Lewis (Remarks on the Use and Abuse of Some Political Terms, 1832):

> Public, as opposed to private, is that which has no immediate relation to any specified person or persons, but may directly concern any member or members of the community, without distinction . . . (27, p. 195)

and Jeremy Bentham's discussion in Principles of the Penal Code, 1867:

> Public Offences. Those which produce some common danger to all the members of the state, or to an indefinite number of non-assignable individuals, although it does not appear that any one in particular is more likely to suffer than any other (27, p. 196).

Barry defines "interests" as follows:

> To say that x is in A's interests is to say that he would want it if he were rational and not altruistic or principled in a certain way . . . (27, p. 191). By saying only "in a certain way" I cover myself against the case where someone wishes to use his own opportunities in the way another would like" (27, p. 193).

An action or policy is, thus, in a man's interests if it increases his opportunities to do what he wants except in the case where he knows he is likely to be irrational later on and would like to take precautions in sane moments. And with regard to "common interests" he argues:

> To say that two or more people have a common interest is to say that there are two policies x and y such that both persons (or all of them) prefer x to y from the point of view of their own interests. On this definition it is safe to say that <u>any</u> two people have a common interest as between <u>some</u> two policies and <u>any two</u> people have a divergent interest as between <u>some</u> two policies; and the same is <u>a fortiori</u> true of groups. . . . Instead of speaking in blanket terms about people or groups with common or opposed interests, we should speak of people or groups whose interests coincide or conflict with respect to the adoption of x rather than y. If once we do this it becomes plain that there are considerable possibilities for "common interests" so interpreted, among all the citizens of a country as well as among wider groups. Nevertheless, common interests in a single action among all the members of a society are not very frequent" (27, p. 199).

It is therefore necessary to seek agreement on policies rather than on particular actions. Policies are designed to affect all alike under similar circumstances (cf. an insurance policy where it is not known in advance who will gain and who will lose, but whoever happens to acquire a claim will be treated like anybody else under the same circumstances). It is thus possible that the public may have a common interest in governmental policies and programs, such as medical care and social

security. However, even policies sometimes benefit some section of the population more or less than another. For these situations a "higher-order policy" which specifies some criteria and says that any action or policy which satisfies these cirteria is to be accepted, is required. Criteria could be determined by majority vote or, in theory, by maximizing utility, or in different other ways (not specified). Barry concludes:

> It is important to recognize that where this higher-level policy is in operation, it is that which is "in the public interest" and not the particular policies and actions which are carried out because they satisfy it; e.g., that it is the "majority principle" or the "principle of utility" which is "in the public interest," rather than this or that application (27, p. 203).

In summary then, Barry argues that members of a public do possess common interests which have to be protected by some higher-level policy and that recognizing and implementing such policy in terms of certain (indeterminate) criteria is that which is in the public interest.

Lawmen

According to John D. Montgomery the concept of public interest had its origins in Western law and philosophy. "It is closely related to the emergence of individual economic and other legal rights, and to the Western view of the state's role as an ultimate guardian of the individual right to moral self-fulfillment" (28, p. 218). It is, therefore, not strange to find many attempts at defining the public interest in statutes and court records, without the achievement, however, of a universal definition. The following two are quoted by Montgomery:

> Public interest means . . . something in which the public, the community at large, has some pecuniary interest, or some interest by which their legal rights or liabilities are affected. (State v. Crochett, 206 Pac 816, 817).
>
> Property becomes clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. It then becomes subject to control by the public for the common good. (Munn v. People of State of Illinois, 94 U.S. 113, 126). (28, p. 222)

These two definitions are typical of the legal definitions which are sometimes simply stated authoritatively without much justification being offered. Although notions like "the public at large," "public consequence," and "common good," are usually incorporated, the specific contents vary with the circumstances. The fact that general criteria for determining the public interest do exist is noted by Professor James C. Bonbright, a recognized authority on public utilities (29, Chapter III). In his view the public interest concept is very indefinite to apply but the situation is not as frustrating as it might seem for at least two reasons:

1. The basic conception of social welfare as the welfare of the people, the state only being an instrument for attaining such welfare, may be accepted as "given."
2. Widely held goals of economic policy may also be accepted as "given." In this respect consumer sovereignty is a general criterion.

The lawmen do not seem to have much trouble in determining from case to case what is in the public interest. They are at ease with the concept and use it without hesitation. This is well illustrated by Julius Cohen, Professor of Law, who appears to be completely confident in the handling of the concept. He states straightforwardly:

> Aside from its use as a phrase of art, such as in the Federal Communications Act, or in the oft-used "business affected with a public interest," it is, I submit used in a dual sense: first in a logical sense - i.e., to explicate the <u>meaning</u> of the established basic values of the community. Thus, it would be in the public interest to pursue a certain goal because it would be consistent with the <u>meaning</u> of a basic community value. Second, it is used in an instrumental sense - i.e., that a policy would be in the public interest if its consequences would implement one or more of the established basic values of the community (30, pp. 155-156).

The scope of the community that he has in mind is determined by the values held by the members. These values bind together and weld diverse human forces and relationships into an ordered way of life. The values are "held by humans; they concern the relational aspects of man in his social capacity; they are shared by humans, and in this sense take on the aspect of common or community values" (30, p. 156). These basic values ultimately determine what satisfactions are to be sought, who are to be satisfied, and at what expense. The concept of public interest is, however, neither a comprehensive nor a supreme and insuperable consideration for lawmen. Still, they have a "vested interest in 'the public interest' as an operational concept: They would be tongue-tied without it" (30, p. 160). Apparently Cohen uses the word "operational" here in the layman's sense. Elsewhere, however, he gives an example of the use of the concept in the operational sense, viz., the prohibition of deceptive television commercials in the public interest. As an example of using the concept in the logical sense he offers this one: when it is urged that it would be in the public interest to grant a right to remain silent before congressional committees, what is suggested is that it would be consistent with the Bill of Rights which enumerates certain accepted basic community values of the citizens of the United States. Community values include concern not only for the majority, but

usually for the minority as well.

> There is a public interest in the private rights of those who elect not to follow the crowd, because it is consistent with one of our basic community values. . . . All conflict situations which call for government action . . . invite a consideration of community values, and hence of public interest. They may involve situations in which socalled "special" interests are arrayed against the quantitative bulk of the community. But to limit the concept to this conflict pattern alone would, in my judgment, place an unwarranted crimp upon its usage (30, pp. 157-158).

A reasonable guess would perhaps be that the kind of reasoning presented so clearly by Cohen is the same kind used by the draftsmen of statutes and judges of the courts. They accept the factual situation concerning dominant community values in the country, as they see it, and regard it to be in the public interest to protect these values. This leaves, however, one thorny question unanswered: Should the public authorities attempt to influence community values which they regard as undesirable or as not in the real interest of the public?

Another Professor of Law, Edgar Bodenheimer, demonstrates the capacity to strip the concept of public interest from ambiguity, vagueness, and uncertainty. He introduces his "Prolegomena to a Theory of the Public Interest" (31, pp. 205-207) by exposing convincingly the "fallacy of quantitative determination and the fallacy of determination by governmental fiat" (31, p. 211). The fallacy of quantitative determination originated with Jeremy Bentham who identified the interest of the community with "the sum of the interests of the several members who compose it" (32, Chapter I, iv). Bodenheimer points out:

> Inasmuch as Bentham conceived of the individual as a selfish being, as Bertrand Russell has observed, the Benthamite doctrine could be accepted only on the supposition that the sum total of selfish individual actions could be equated with the maximum happiness of the community. Although this view was once widely held, it has become disconfirmed by the experience of the last hundred years (31, p. 206).

In regard to the second fallacy he points out that government officials may misconceive the community interest or may be motivated by selfish desires in exercising their responsibilities and may interpret their functions purely in terms of personal advancement or aggrandizement. He then proceeds to seek for "positive and nonsubjective standards which will render possible or, at least, facilitate the task of identifying the meaning of the concept of public interest." His argument rests on the following assumption:

> The public interest must be understood as the genuine interest of the whole community and not as the camouflaged interest of an elite or minority actuated by totally self-serving goals. . . . The further consideration of rational judgment must be added that no plausible ground can be found why the world should be considered the playground of a few for whom the large majority of men and women are mere objects rather than human beings entitled to be treated as ends in themselves (31, pp. 211-212).

Then follows his psycho-sociological argument:

> It is submitted that what all citizens want if they look at the problem intelligently and conscientiously, without in any way sacrificing their personal needs and wants, is a well-ordered and productive community in which everybody has an opportunity to develop his capabilities to the fullest . . . Human happiness . . . rests on the fulfillment of multiple demands . . . According to the testimony of the teachers of wisdom, the greatest happiness is derived, not from mere satisfaction of animal instincts, but from making contributions (large or small) to human civilization in the material, mental, ethical, religious, or aesthetic spheres of life (31, pp. 212-213).

Therefore:

> All measures which promote, serve, and benefit the human desire for affirmative and constructive participation in the enterprise of civilization must be deemed to be in the public interest because they increase the good of all as intelligently conceived (31, p. 213).

In support of his views, Bodenheimer cites the Austrian jurist Alfred

Verdross* and also Erich Fromm, and Jean Dabin.** To promote a social system in which the individual is free to act in the ways postulated above (individual freedom), but with full consideration of the rights and desires of others (public necessity), policy-makers have to look to the "social constituent in human beings" and attempt to

> interpret their interests in the light of the standards that would guide a rational and conscientious man aware of the fact that he does not live in this world alone but must adapt his conduct to the interests of others and the good of the whole (31, p. 217).

It appears that the lawmen's convictions are based, as can be expected, on notions of justice, order, fairness, equity, conservation of community values, freedom of the individual (provided he does not encroach on the rights of his fellowman), and human dignity. The fact that this concept is highly constitutive does not plague the jurist because he looks to the judicial system to make public policy operational, even to test the constitutionality, as a matter of public interest, of laws enacted by governments.

Political Scientists

The philosophy of those political scientists who find merit in the

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* . . . the bonum commune aims neither at the maximum satisfaction of individual desires nor at the promotion of collective utility or expediency, but at the establishment of social conditions under which individual persons are able to build, through industry and productive work, a life which is in consonance with the dignity of the human being (31, p. 213).

** What the public requires as its own good, what is specifically the good of all without distinction, is a sum total of general conditions under the protection of which the legitimate activities of everyone within the public may be exercised and developed comfortably (31, p. 213).

concept of public interest is clearly reflected in the following words written by Stephen K. Bailey:

> It is no more than an act of faith, but I cannot help believe that - in spite of operational dilemmas - "the public interest" is the central concept of a civilized polity. Its genius lies not in its clarity but in its perverse and persistent moral instrusion upon the internal and external discourse of rulers and ruled alike (33, p. 106).

When he goes to the extreme of describing it as a myth however, many political scientists will disagree. He even proposes that the myth be given "rational content," as follows:

> There is perhaps no better example in all language of the utility of myth than the phrase "the public interest." It is balm for the official conscience. It is oil on the troubled water of public discontent. It is one of society's most effective analgesics. But to have this phrase serve this purpose over time, public servants must be able to give it a rational content anchored in widely shared value assumptions (33, p. 97).

The best solution that Bailey can offer is "the establishment of value priorities which can guide the searching mind in its quest for rational judgments about the public interest" (33, p. 106). While this solution provides some operational guidance to the official whose responsibility it is to apply the policy, it shifts the real burden, that of deciding on the value priorities in the first place, to other shoulders, be it those of higher officials, the judicial process or the populace.

While Bailey regards the concept as a myth, a mere politial tool to satisfy divergent interests and desires, C.W. Cassinelli, Professor of Political Science, elevates it to a standard - "the highest ethical standard applicable to political affairs" (34, p. 46).

> The public interest is a standard of goodness by which political acts can be judged; action in the public interest, therefore, deserves approval because it is good . . . The public interest, as an ethical concept, has functions quite different

> from those of analytic models . . . The word "public" means that the ethical value in the standard of the public interest applies to every member of the political community . . . to say that an action is in the public interest is to judge it consistent with a political situation that is beneficial to everyone, if not immediately at least in the long run, and whether or not everybody realizes it (34, p. 46).

He equates "the public interest" to the "final political good" and would agree to methods of coercion, if necessary, to overcome the opposition of elites or masses to the realization of the public interest interpreted as political freedom. The fact that the standard provides no operational guidelines does not concern him since its function is "quite different from those of analytical models." What Cassinelli has in mind, apparently, is that the standard should guide policy-making at a very high level rather than policy implementation at the administrative level.

The main thesis of the political scientist J. Roland Pennock is that much of the vagueness of the concept disappears when it is placed in specific context. Although "beauty" or "a beautiful woman" cannot be defined operationally, nobody demands rejection of these concepts.

> And so it is with "the public interest": much of its vagueness disappears when it is placed in specific context . . . . Thus at any given time the way in which a regulatory commission is to pursue the public interest, while open to dispute, is far more clearly defined than is the phrase "the public interest" considered <u>in vacuo</u> (35, pp. 178-179).

In answer to the question whether the public interest is anything more than the sum of private interests, he offers four propositions:

1. The public interest is not confined to interests that are recognized by those whose interests they are, e.g., speed laws.
2. The public interest includes the interest of persons who are not yet born.

3. Private interests must be conceived as including the individual enjoyments, satisfactions, fulfillments, etc. that come only in and through society.

4. Anything that is part of the public interest must be capable of recognition by individuals as an interest that they have in the sense that they wish to see it furthered or think it ought to be furthered.

Pennock's interesting argument in support of these propositions follows:

> When one thinks what a life of solitude would be like it is apparent that most of our interests are dependent upon society. And when we think of the pleasures of each other's company and of conjoint activity we see that many of our interests are directly social. Society, and its supporting structure, government, becomes the source of satisfaction of so many of our interests that we even come to value them, as we say, for their own sakes. That is to say, we acquire an interest in the preservation and further development of society and government as essential means to the satisfaction of many different and more specific interests (35, pp. 180-181).

He concludes that the public interest is a spur to conscience and to deliberation. Private interests are not exhaustive of the public interest and they include much more than self-interests.

> A term that plays this role, even though it lacks precision, is as valuable as it is inescapable. Moreover, in many particular applications, the context of the situation gives the phrase greater definition (35, p. 182).

The public interest as an ultimate standard or criterion for the regulation of organized society is also the essence of John D. Montgomery's message:

> In spite of the difficulty of arriving at an adequate definition of public interest in universal terms, the concept is of overwhelming importance. It offers, to the western mind at least, the ultimate ethical justification for demanding the sacrifices which the individual may be called upon to make in the interest of the state, and it prescribes certain of the ultimate goals of organized society (28, p. 218).

Getting down to matters of practical policy, he singles out the economist's concept as a useful definition of public interest. The economist's approach provides an operational assumption - that "growth" in its economic sense is desirable and is, therefore, in the public interest.

> If the probability and desirability of material development may be assumed, economic theory may produce means both of clarifying the requirements of development and of contrasting them with the "opportunity costs" of satisfying consumer demands. Economic theory may also be used to justify the allocation of resources on a national basis, and to support the degree of national planning necessary to accomplish this conceptual task (28, p. 220).

On this optimistic note the survey of the views of the political scientists is terminated and the economic concept which offers some promise, according to Montgomery, is examined in turn.

Economists

That the economic behavior of individuals is of consequence to the public interest is the theme of the following oft-quoted passage from Adam Smith's classic work, The Wealth of Nations:

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it (36, p. 423).

During the two centuries that have elapsed since Adam Smith wrote these famous words, economists have not only sharpened considerably their

analytical tools, but also have added new ones to enable them to deal with a changed economic environment. The most important changes are the emergence of the modern large corporation, strong legalized labor organizations, and the increasing involvement of government in social and economic affairs. Although economic analysis has improved, many issues are still controversial. Some economists still believe in the efficacy of the market mechanism while others, e.g., John Kenneth Galbraith, have lost faith in it. The predominant view, however, is that the market can perform a useful socio-economic function, provided governmental action is taken to control forces tending to weaken its efficiency. For fairly recent views on the economist's conception of the public interest, three economists are consulted, viz., R.A. Musgrave, Gerhard Colm, and Richard T. Gill.

In an article entitled "The Public Interest: Efficiency in the Creation and Maintenance of Material Welfare," Musgrave outlines "what economists have to say about 'The Public Interest' or, as they call it, the problem of welfare economics"(37, pp. 107-114). He states the theory rather concisely as follows:

> The tradition of economic analysis anchors in the hedonistic proposition whereby individual interests, by courtesy of the invisible hand, coincide with the public interest. More specifically, economists have argued that given the state of income distribution and the principle of consumer sovereignty - the rule that individuals should be free to use their income as they see fit - the play of free competition will result in the most efficient use of resources. The outcomes will be most efficient in the sense that scarce resources are used so as to maximize consumer satisfaction. . . . This line of reasoning is still the backbone of normative economic analysis (37, pp. 107-108).

According to Musgrave, certain situations do exist in which the market, left alone, does not satisfy the conditions of efficiency. It is then considered to be in the public interest to take corrective

measures through public policy. Following are a few examples of such "break-downs":

1. Monopolizing behavior of large firms may interfere with the ideal of free competition. Public measures, such as antitrust legislation and regulation of public utilities, are consequently required.
2. Diminishing cost industries offer a technical problem. Ideally, marginal cost must equal price or average revenue, but average cost is above marginal cost. A "public interest" solution is a governmental subsidy. This poses further problems: How to determine the proper amount and how to finance it.
3. Production often involves so-called "externalities," i.e. benefits or costs for which the particular producer is not charged or remunerated. Efficient resource use requires that these benefit and cost components be considered, but again the problem is how to determine the benefits or costs and who should receive or pay the amounts involved.
4. Another problem arises in connection with time preference. The relative value of present as against future consumption may differ greatly from the point of view of the individual and society. Thus public policy to control exploitation of natural resources is required in the public interest on the assumption that future generations are included in "the public."

The general welfare rule is that a rearrangement of productive resources is "efficient," i.e., in the public interest, if someone gains satisfaction while no one loses any. This requires a method for measuring personal satisfactions and preferences. Economic preference is

expressed in the market-place by the number of "dollar votes" that each product receives. Other preferences are revealed by the political process, but here the problem is how to distribute the right to vote and what voting rule to apply. The implicit assumption underlying this statement is, of course, that the public interest can or should be determined by the populace. The validity of this assumption is questioned by some theorists.

Problems of resource allocation are not the only "public interest" economic phenomena studied by economists. Since the thirties emphasis has shifted to problems of stabilization of employment, price levels, and economic growth. Assuming stabilization to be in the public interest, economic analysis can contribute solutions towards achievement of this goal. The matter has, however, been complicated by arguments for the rejection of the traditional assumptions of a given distribution of income and of consumer sovereignty. How income <u>should</u> be distributed and who <u>should</u> decide matters of resource allocation (if not consumers) involve value judgments and are, thus, outside the domain of economics, at least to Musgrave's way of thinking. He prefers to define the economic concept of public interest narrowly as "efficiency in the creation and maintenance of material welfare."

Another economist, Gerhard Colm (38, pp. 115-128), first refutes Anthony Downs' theory of democracy "based on the assumption that there exist only individual self-interests," which are primarily considered by both rulers and ruled, and then proceeds to suggest four levels from which the concept of public interest may be analyzed: meta-sociological, sociological, judicial, and economic. Although he presents very interesting arguments about the meta-sociological and sociological levels,

attention will be focussed on his economic views.

Whereas public policy to support the public interest was, up to about the thirties, more or less limited to regulatory functions to protect free competition and prevent exploitation by natural monopolies, the U.S. government has developed a more affirmative concern in the public interest at the economic level in recent decades. The "vague concept" of the public interest has been translated into specific objectives or "goals" from which operational concepts, such as high employment levels and stable economic growth evolved. Colm presents the following classification:

> We may perhaps distinguish two kinds of goals that are related to the public interest. In somewhat arbitrary terminology I have called one kind the performance goals, the other the achievement goals. Performance goals refer to the smooth operation of the economy, as evidenced by low unemployment, reasonable price stability, and an adequate rate of economic growth, . . . Achievement goals, on the other hand, refer to specific content of the public-interest concept, such as an adequate standard of living for the people, adequate education, defense, conservation and development of resources, a proper contribution to underdeveloped countries. . . . This means that productive resources should be allocated to the various purposes in a manner corresponding to their relative urgency and assuring full, but not excessive and therefore inflationary, use of resources (38, p. 124).

Since all these goals are reflected in the national economic budgets, they represent a "quantified expression of the public interest."

> Thus through the national economic budgets the vague concept of the public interest can be transformed into an operational instrument (38, p. 125).

The public interest refers to adequate satisfaction of individual wants as well as to public operations. Only where private operations cannot adequately satisfy individual wants is there any reason for government action, at least in conformance to current interpretation of the public interest in the United States. Colm's conclusions and convictions can

perhaps best be summarized in his own words, as follows:

> The vague concept of the public interest loses much of its vagueness as a result of political debates, judicial interpretations, and translations into specific goals of economic performance and achievement. As a matter of fact, it is difficult to imagine that politicians, statesmen, judges, and officials concerned with the formulation of government policies could do without this concept. Even a person who is wholly agnostic with respect to the public interest as a meta-sociological idea may find that the concept is needed at least as a working hypothesis, regardless of whether it corresponds to a "reality" (38, p. 127).

In the preface to his introductory book on economics, Economics and the Public Interest, Richard T. Gill states:

> In an age when economic issues affect every individual in the nation, the need for a concise but still authoritative account of economic analysis is particularly pressing. . . . In choosing what to include and what to exclude, I have constantly asked the following question: what are the issues of public concern on which common economic analysis has the most direct and immediate bearing? (39, preface)

The material in his book includes the description of a market economy; a planned economy; a mixed economy with specific reference to the modern corporation, labor unions, and government's role; Keynesian macro-economic analysis; fiscal policy; monetary policy; inflation; international trade; economic growth; problems in underdeveloped countries; and the problems of affluence. In other words, Gill conceives the public interest as being affected in various ways by economic activity and economic policy at all levels, i.e. the private sector, the public sector, international trade, and national and international economic policy. The function of economics is viewed by him as follows:

> Faced with such global questions, economics alone will not provide all the decisive answers. Hopefully, however, it will form an indispensable background for their intelligent discussion (39, p. 280).

Gill points to the current awareness of the increasing need for governmental intervention in many areas of economic life caused by a situation

in which the needs of society seem to involve those "external" effects where private and social interests will generally diverge. Thus,

> . . . the case can be made that our society has reached a point where the private versus public balance must be shifted in the direction of the latter. This is one of the main themes of Galbraith's Affluent Society. At the same time, however, there is another current in our society that seems to cut across this apparent need for more governmental intervention. This second current involves a criticism of the increasing bigness, impersonality, standardization, and bureaucratization of our national life. In its extreme form, this criticism manifests itself in a thorough-going distrust of "the establishment" . . . In a more moderate form, the criticism emerges as a desire for more decentralization in governmental action through increasing reliance on state and local governments and through more stress on voluntarism at the personal and community levels (39, p. 279).

Gill does not state an assumption that economic action involves any public interest consequences. He takes it for granted and proceeds to explain the kinds of economic analysis that enable officials to arrive at decisions favorable to the public interest. Like most economists he limits the economist's role to that of providing the analytical tools for aiding the decision-makers and appraising the consequences.

Conclusions

The literature search reported in this chapter suggests at least two conclusions. First, the concept is clearly controversial. No consensus exists as to its meaning and definition. That a generally accepted definition will soon be formulated seems doubtful because subject-matter of the concept is highly abstract. The moral of this, for anybody who wishes to include the concept in a theoretical structure, is that the meaning of the concept cannot be taken for granted but has to be defined for his particular purpose.

Second, the majority of social scientists are in favor of retaining the concept as a moral guide by virtue of "its perverse and persistent

moral intrusion upon the internal and external discourse of rulers and ruled alike" (37, p. 106) and because "it offers . . . the ultimate ethical justification for demanding the sacrifices which the individual may be called upon to make in the interest of the state, and it prescribes certain of the ultimate goals of organized society" (28, p. 218). The importance of the concept resides in the underlying human relations problems with which it deals. In any community conflicting interests are always present. A guiding theory or principle is required to adjudicate in such matters. This is the function of the public interest concept. Hence, more good is done by efforts to define the concept than by searching for grounds on which to reject it. The next chapter is therefore devoted to the search for a general meaning as well as operational definitions of the concept of public interest.

CHAPTER 3

THE PUBLIC INTEREST: MEANING AND DEFINITIONS

The meaning of a concept is expressed by defining it. According to John Dewey, meaning is established by agreement (40, p. 47). The definition of a concept expresses, therefore, the meaning agreed upon by those persons who refer to the concept in discourse. This explains the statement that concepts are established by agreement. Once they are established, they can be defined so as to express their meaning clearly in view of enhanced communication with those who were not a party to the agreement.

Definitions may be either constitutive or operational. Constitutive definitions, according to Thomas R. Prince,

> . . . are like dictionary definitions of a concept in that the explanation is based on relating the concept that is being explained to one or more other concepts. The descriptive aspects of this concept will refer to other concepts, which, eventually, will refer back to the original concept. Thus, the dictionary type of definition tends to be circular (41, p. 62).

The fact that constitutive definitions tend to be circular does not invalidate them or render them useless. If the other concepts used to explain them are clear or settled antecedently by agreement, the definition serves a useful purpose. Unfortunately, the possibility always exists that the other concepts used to define a particular concept may be more controversial than the concept itself. It is, thus, difficult to formulate constitutive definitions which are unambiguous and generally

acceptable. To alleviate this problem, P. W. Bridgman developed the idea of operational definitions, based on his views about "meaning" as expressed in his 1932 publication, The Logic of Modern Physics. Quoting from this source, Stuart Chase explains operationalism as follows:

> "The true meaning of a term is to be found in observing what a man does with it, not what he says about it." Scientists, through observing, measuring, and performing a physical operation which another scientist can repeat, reach the solid ground of agreement and of meaning. They find the referents. "If a question has a meaning, it must be possible to find an operation by which an answer may be given to it. It will be noted in many cases that the operation cannot exist and the question has no meaning" (42, pp. 11-12).

The meaning of a concept as expressed in an operational definition is specific and unambiguous. Operations are specified to be performed under stated conditions. Thus, operational definitions are explained by Russel L. Ackhoff, as follows:

> An operational definition of a concept, then, should state explicitly the conditions under which and the operations by which questions concerning the concept involved ought to be (ideally) answered (41, p. 62).

The difference and relationship between the two types of definition is illustrated by two of the definitions of the concept of public interest quoted in Chapter 1. "The public interest is what men would choose if they saw clearly, thought rationally, acted disinterestedly and benevolently" (Lipman's definition) may be regarded as a constitutive definition and "a decision is said to be in the public interest if it serves the whole public rather than those of some sector of the public" (Meyerson and Banfield) is an operational definition. While no known instruments exist to measure whether or not a person "saw clearly, thought rationally, and acted disinterestedly," it is possible to determine whether a measure or policy affects every single member of the public alike or only a sector of it. Although operational definitions

appear to be superior to constitutive definitions on the ground that they are susceptible to empirical verification, the latter are useful as guidelines for the formulation of the former. Thus, it may be held that a person who "thinks rationally" is "neutral between egoism and altruism" (27, p. 193) and will agree that a public measure should not solely serve his own ends, nor solely those of others, but should be applicable to all alike. Hence, it can be said that the operational definition of Meyerson and Banfield is derived from the constitutive definition of Lippman.

Accounting, as a measurement discipline, needs operational definitions of its concepts. But, as pointed out by Norton M. Bedford, "how do we know that we have accurately observed the proper set of operations?" (43, p. 9) Bedford cites Henry Margenau on the point that concepts should, ideally, be defined both constitutively and operationally, as follows:

> . . . it is necessary . . . that every accepted scientific measurable quantity have at least two definitions, one formal and one instrumental. It is an interesting task to show how some sciences fail to become exact because they ignore this dual character of the definitory process. Omission of operational definitions leads to sterile speculation . . . ; disregard of formal (or "constitutive") definitions leads to that blind empiricism . . . (43, p. 7).

In recognition of the need for both types of definition, an attempt will now be made to find a descriptive meaning for the concept of public interest which can be expressed constitutively as well as operationally. A penetrating inquiry into the conceptual meaning of "public interest" had been undertaken by Richard E. Flathman and the result of his inquiry was published in 1966 under the title The Public Interest: An Essay Concerning the Normative Discourse of Politics (44). His analysis and conclusions, which are summarized below, provide the foundation for the

present inquiry into the meaning of the public interest concept.

The Study of Richard E. Flathman

In the preface to his book, Flathman indicates that he relies heavily on "ordinary language-philosophy" or "post-positivistic philosophy" in addition to standard methods of political study (not specified by him). Thus, he opens his study by examining words and their meanings, differentiating the primary meaning of words or concepts from their descriptive or secondary meaning. Drawing on R. M. Hare's The Language of Morals (45), he uses the word "good" to illustrate his point. According to Hare, the word "good" has a constant meaning which, once learned, can be understood no matter what class of objects is being discussed. It is a commendatory meaning, i.e., it is used to express approval or commendation. This is its primary meaning which is constant; the word is always used to commend. Fountain pens are, however, commended for quite different reasons than men, automobiles for reasons other than television sets, and so on, yet the word "good" can be used in all cases and the listener understands the message. However, when so used, the speaker must be able to give reasons why he regards the object as being good, i.e., he must supply a descriptive meaning which supports his commendation. While the primary meaning is constant, always commendatory, the descriptive meaning may and usually does vary, depending on many things, including the identity of the object and the surrounding circumstances. In Flathman's opinion, this analysis is equally applicable to the concept of public interest. After illustrating at length that the primary function of the public interest concept is to convey

approval or commendation of public policy in ordinary language, he points out that the significance of the concept is not exhausted when this aspect of its use is analyzed. The task remains to find a descriptive meaning for it.

As a first step towards the determination of a descriptive meaning for the "public interest," he proceeds to analyze the concept "interest." Applying the method of ordinary language philosophy, he develops a model of the concept as illustrated in Figure 3-1.

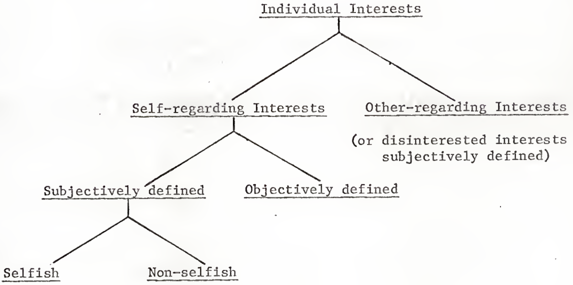

Figure 3-1. Flathman's Model of the Concept "Interest"

Source: Richard E. Flathman, The Public Interest (John Wiley & Sons, Inc., New York, 1966), p. 27.

On the basis of this model, several questions can be discussed with reference to the relationships between individual interests and the public interest. For instance: To what extent, if any, is the possession of "other-regarding interests" a normal human characteristic? When

Benthamites argue that disinterested, or other-regarding political behavior is rare, ineffective, and unreliable, the most plausible foundation for their view is egoism. If egoism can be substantiated, the notion of disinterested behavior must be abandoned. If not, there is reason to believe that many individuals act in the interest of others for no more than their own subjective satisfaction. The factual position in this regard holds significant consequences for the idea of public interest. On the assumption that disinterested behavior is possible, Flathman argues:

> We do not urge men to do things that are impossible for them to do or condemn them for doing things they have to do. "Ought" implies "can." Whatever the empirical incidence of dininterested behavior might be, then, one task which lies before the student of politics is to understand the potential significance of such behavior. If we learn that such behavior is potentially significant and valuable but empirically rare and insignificant, we might better understand some of the characteristics of our politics. We might then be moved to take measures to increase the incidence of disinterested behavior. The empirical finding that disinterested political behavior is rare and insignificant does not warrant the conclusion that political life must do without such behavior or that it would be improved if it did (44, p. 29).

And he concludes that "a politics of public interest would be impossible in a system in which disinterested political behavior was unknown and unmourned" (44, p. 30).

The second question to be considered is the relationship between self-regarding interests and public interest. "Objective interests" relate to the profit, advantage, or welfare of the individuals whose interests they are considered to be. The significance of this classification for a policy of public interest is that objectively determinable interests can be isolated for the purpose of gathering information about the expected consequences of alternative policies and the development of criteria for policy evaluation. "Subjective self-interests," on the

other hand, can only be ascertained by canvassing the wishes of the public. Whether such wishes should be implemented depends again on whether they are "selfish" or "non-selfish." Since the clash between self-interest and public interest is often rooted in selfishness, this notion deserves more attention. The following quotation by Flathman from P. H. Nowell-Smith's Ethics (Penquin Books, Inc., Baltimore, 1954) explains selfishness very adequately:

> To be selfish is not to do what one wants to do or enjoys doing, but to be hostile or indifferent to the welfare of others. It comes out in two ways. (A) A man whose dominant desires were for his own pleasures . . . or who seldom or never wanted to do good to others would be a selfish man. (B) A man who does what he wants to do or what he likes, when he does it at the expense of others, is a selfish man, even if what he does is not in itself selfish. To eat when one is hungry is certainly not altruistic: but it is not selfish either. What is selfish is to eat the last biscuit when others are hungry (44, p. 28).

Thus, although a man is usually regarded as the best judge of his self-regarding interests, it may not be in the public interest to implement his wishes. A man's pursuit of his own interest often has consequences for others. A policy of public interest demands that such consequences be considered, evaluated, and reconciled as far as possible.

Any attempt to arrive at a descriptive meaning for the public interest concept must be preceded by due recognition of and deliberation on this variety of individual interests. Questions to be answered include: What is the empirical incidence of disinterested behavior? Should measures be taken to increase the incidence of disinterested behavior? How efficient are the tools for analyzing and measuring objectively defined self-interest? How can the prevalence of selfish self-interest be determined and to what extent is it desirable to curtail selfish pursuit of such interests? These and similar questions cannot be adjudicated on the basis of an analysis of the word or concept "interest" alone. One of the first problems to be solved con-

cerns the place to be given to the satisfaction of subjectively defined individual interests in the descriptive meaning of public interest.

This problem involves an understanding of both psychological and sociological aspects of human behavior as well as the philosophical, political, ethical, and religious attitudes of the community on behalf of which the concept of public interest has to be given a descriptive meaning. Considerable validity attaches to the views of Bentham and later individualist democrats that "self-interest is the only sure springboard to thought and action, and it is only when the individual is allowed to pursue his own interests that his abilities will be fully developed and utilized" (44, p. 34). This philosophy is given credence through practice in modern democratic states where decisions left to individuals include: "vocation, place and mode of residence, political and religious belief, association, avocation, possession or not of most types of property, marital status, family size, diet and a host of others" (44, p. 32). A case can, therefore, be made that expressed individual interests be considered a legimate and important part of the public interest.

Admission of individual interests as a component of public interest immediately creates a problem: how to deal with interest diversity and conflict. This question has at least two dimensions, both involving moral decisions; viz., how <u>should</u> individuals themselves behave when their actions have consequences for the interests of other individuals and, secondly, how <u>should</u> public policy treat conflicting individual interests? In regard to this question, it can be noted that a number of moral "principles" or "canons" do exist. An example is the maxim: "no individual should be judge in his own case," the implications of

which are explained by Flathman in the following passage:

> The first consequence of interdependence and conflict is that perceived or expressed self-interest as such cannot define the public interest. The mere fact that an individual perceives X to be in his interest cannot create imperatives concerning the content of the public interest. Aside from the practical problems this position would create, it violates the maxim that no individual should be judge in his own case, and it releases the individual from all duties to other men in the area of public policy. As long as individual interest is all that is offered to justify X, the fact that another man perceives X to be contrary to his interest will be of equal moral weight (44, p. 38).

Also implicit in the above argument is the principle that "rights imply duties." If A has a right, other individuals in the same society have the duty to recognize A's right and A has the duty to recognize similar rights that those other members of his community have against him. This is the moral foundation for Edgar Bodenheimer's viewpoint that "what all citizens want . . . is a well-ordered and productive community in which everybody has an opportunity to develop his capabilities to the fullest . . ." (31, p. 212). Not only should the members of a community respect each other's interests, but they are also "obligated (not merely forced) to obey particular commands and to conform to particular policies which they regard as contrary to their personal interests." (44, p. 38), provided that such commands and policies will promote the public interest.

Another principle mentioned by Flathman is the "universalizability principle" which states that: "what is right (or wrong) for one person must be right (or wrong) for any similar person in similar circumstances" (46, p. 5). An individual who demands that the state act in a certain manner must therefore be demanding that the action be imposed upon all members of society, including himself. Similarly, the guiding rule for the state, when it is called upon to adjudicate on conflicting interests,

is to make its decisions or actions binding on all members of society (or a class of society) alike, i.e., on "similar persons similarly situated" (44, p. 42). The universalizability principle does not solve all problems of interest conflict. The state, at times, has to take measures that are contrary to certain individual interests but are considered, nonetheless, to be in the public interest. In choosing a policy to be made binding on all, the relative expected consequences of the available alternatives must be determined. This can be referred to as the "principle of consequences" and can only be applied if it is possible to identify general principles concerning the manner in which consequences can properly be assessed.

It is argued above that a politics of public interest requires individuals to consider the impact of their behavior upon their fellowmen and to conform to the demands of the universalizability principle, i.e., to move beyond the idiosyncratic and susjective towards the ideal of a well-ordered and productive community. But what is the role of authority in the determination of a descriptive meaning of the public interest? Flathman holds that a citizenry which meets the requirements of a politics of public interest can contribute to defining the descriptive meaning of public interest and thereby relieve the burden on those in authority" (44, p. 47). They can, however, never take over that burden entirely. A society that takes public interest seriously requires the assistance of central authority devoted to the service of the public interest. He continues:

> This is true in part because men do not meet the requirements of a public interest politics in anything like a perfect manner. To reject egoism is not to deny the prevalence of selfish behavior. And few of us, steeped as we are in Hobbes, Bentham, The Federalist, and their descendants, expect such behavior to

> disappear entirely. As long as selfish behavior continues, a determinate authority, which exists to promote the public interest, will be needed to control the effects of such behavior and to assert the public interest in the face of selfish demands (44, p. 47).

The objection that central authority cannot understand individual interests perfectly is taken care of by the democratic political process whereby the citizens decide who should occupy positions of authority and whereby safeguards are built into the system to limit the power of the rulers. Although private citizens cannot authoritatively define the public interest, they are able to judge the results of the official definition, incorporated in public policy, as those results impinge on them.

"Public Interest" Defined

Can a general, unchanging descriptive meaning be assigned to the concept of public interest? Stated differently, can the concept be so defined that the definition can serve as a yardstick on the strength of which all actions by rulers and the ruled may be either commended or rejected? Plato thought that this was possible. He believed in the possibility of attaining knowledge about a body of supreme truths or principles that would enable the possessor of such knowledge - the philosopher-king - always to find the right policy that would serve the common good. To date, such a body of supreme truths has not been discovered and mortal men have to settle for something less than final solutions. Most individuals today recognize the contextual dimensions of problems. An assertion that a policy is in the public interest cannot be taken to imply more than that "this policy, under these circumstances, is a commendable public policy" (44, p. 54). It appears therefore that

it is impossible to generalize about the descriptive meaning of the public interest. At best it is possible to generalize about the principles and procedures to be applied in defining it in context. Some of these generalizations involve ethical concepts; e.g., human dignity, personal freedom, equal opportunity, justice, and many more enumerated in the Charter of Human Rights. A number of formal principles such as the universalizability principle and the principle of consequences are also available.

Flathman summarizes his conclusions in the passage quoted below. His conclusion is accepted as a working hypothesis to guide the formulation of a constitutive definition of the public interest from which operational definitions can be derived.

> We conclude that "public interest" is a general commendatory concept used in selecting and justifying public policy. It has no general, unchanging, descriptive meaning applicable to all policy decisions, but a nonarbitrary descriptive meaning can be determined for it in particular cases. This descriptive meaning is properly found through reasoned discourse with attempts to relate the anticipated effects of a policy to community values and to test that relation by formal principles (44, p. 82).

This hypothesis allows the formulation of an indefinite number of definitions of the public interest to fit different situations with varying temporal and spatial dimensions. However, before proceeding to that step a brief analysis of the hypothesis is required.

First, Flathman treats the concept of public interest entirely as a political concept by saying that it is "used in selecting and justifying public policy." This is confirmed by himself in the following words: "It performs a function in political discourse, and it has a logic which, if taken seriously, will influence the kind of policies adopted and rejected and the character of the political process utilized

to adopt and reject those policies" (44, p. 82). Although the concept of public interest is analytically a political concept, it is receiving increasingly much wider recognition in social discourse and philosophical thought. The economist Gerhard Colm, for example, suggests "four levels, or points of view, from which the concept of public interest may be usefully analyzed: meta-sociological, sociological, judicial, and economic (38, p. 119). Ernest S. Griffith, a Professor of Political Science contends that:

> The concept of public interest may be broadly viewed, even to the extent of treating it as roughly synonymous with "general welfare." Such a definition holds it capable of permeating all action, both individual and institutional. On the other hand, it can be construed narrowly, as an attribute of certain acts confined to the governmental sector of human activity. . . . For our present purpose we shall for the most part confine consideration to public interest as manifested in governmental activity, but with full recognition that in a pluralistic society this constitutes but a subheading, albeit an important one, under the broader heading of "general welfare" (47, pp. 14-15).

Concern about the general welfare is not limited to government. Many private citizens and organizations are continuously trying to promote the general welfare according to their personal interpretations of the concept of welfare. The term "social interest" is sometimes used to describe a concept about the interest of society as a whole in contrast with private interests. This is basically a social concept under which a political concept of public interest is a subheading only. All social scientists are interested in such a broad concept and can perhaps contribute towards defining the concept of social interest. Although no general understanding to this effect presently exists, there may be some merit in the course taken by Flathman to reserve, so to speak, the term public interest as a symbol for the political concept.

Second, Flathman is concerned about finding a <u>descriptive</u> meaning

for the public interest. "Public interest," in dealing with ethical considerations, is usually held to be a normative concept. Since normative assertions are not amenable to measurement or empirical verification, agreement is almost impossible. For this reason some theorists prefer to dismiss the concept completely from the social sciences. The problem can, however, be avoided by drawing a distinction between what Ayer calls "normative ethical symbols" and "descriptive ethical symbols," as follows:

> It is advisable here to make it plain that it is only normative ethical symbols, and not descriptive ethical symbols, that are held by us to be indefinable in factual terms. There is a danger of confusing these two types of symbols, because they are commonly constituted by signs of the same sensible form. Thus a complex sign of the form "x is wrong" may constitute a sentence which expresses a moral judgement concerning a certain type of conduct, or it may constitute a sentence which states that a certain type of conduct is repugnant to the moral sense of a particular society. In the latter case, the symbol "wrong" is a descriptive ethical symbol, and the sentence in which it occurs expresses an ordinary sociological proposition; in the former case, the symbol "wrong" is a normative ethical symbol, and the sentence in which it occurs does not, we maintain, express an empirical proposition at all (48, pp. 105-106).

This explains Flathman's desire to find a descriptive meaning for the public interest, i.e., a meaning resting on ethical norms antecedently adopted by the particular society, i.e., standards the existence of which can be verified by empirical investigation. Consequently, the meaning of public interest is different in different societies, depending on their particular ethical standards and community values. It may also change over time so that what is considered to be in the public interest for a particular community today may be considered contrary to the public interest at some future date. Some of these values change more rapidly than others; some may last ten years while others hold good for centuries. Thus, the concept of public interest must be regarded as consisting of a

few, if any, static properties and an indefinite number of properties which are dynamic to varying degrees.

Third, a method of finding the descriptive meaning of public interest for a given society is suggested by Flathman, namely, "reasoned discourse." The discourse is to take the form of relating expected consequences of public policies to community values. Public policy is selected from among a multitude of activities that may affect the whole or significant sections of society because the author constrained his conception of public interest to the political sphere. Community values are apparently taken as either known to or determinable by the architects of public policy. In other words, it is the function of official bodies created by the citizens for that purpose to determine and interpret the community values and then to formulate public policies that best serve or articulate those values, norms, or standards. It is also contended that certain formal principles exist which can be utilized in the process of relating expected consequences to community values, for instance the universalizability principle, and the principle that rights imply duties.

Fourth, Flathman's conclusion does not indicate the constitutive nature of the concept, except for stating that it is a "general commendatory concept" and that its meaning depends on community values. Hence, a constitutive definition of public interest is: To say that an action is "in the public interest" means that it is commended because it is consistent with the ethical norms of the particular community. This definition may not be universally acceptable. Is it, for instance, in the interest of a community of scalp-hunters to satisfy their wishes in spite of the fact that their custom may lead to the extinction of their

race? This is, however, an extreme case and does not prove that community values should not receive high priority in the determination of the public interest for a given society. However, it does illustrate how difficult it is to formulate a generally acceptable constitutive definition of the concept of public interest. Reference to Chapter 2, the present chapter, and other relevant literature reveals a large number of properties suggested by many writers that should go into the make-up of the public interest concept. A few examples are:

1. Serving the ends of the whole public rather than those of some sector of the public.
2. Conservation of natural resources for the sake of posterity.
3. Respect for the rights, interests, and desires of others.
4. Regard for the rights of minority groups.
5. Submission to compromise in order to settle cases of conflicting interests.
6. Equity, justice, fairness, due process.
7. Maximization of interest satisfactions.
8. Establishment of social conditions under which individual persons are able to build a life which is in consonance with the dignity of the human being.
9. The sum total of general conditions under the protection of which the legitimate activities of everyone within the public may be exercised and developed comfortably.
10. The individual enjoyments, satisfactions, and fulfillments that come only in and through society.
11. Material welfare, economic growth, and economic stability.
12. Preservation of the human race.

Thus, it is not strange that he does not attempt to formulate the concept constitutively. Instead, he suggests some operations which can be performed to serve the public interest, i.e., determine the community values, relate the expected consequences of alternative policies to these values, and make a rational choice. Since he views public interest as a political concept, the prescription is directed towards government, its agencies, and the judiciary. Assuming then that these official bodies do in fact formulate policies and decisions consistent with their interpretation of community values, the said policies and decisions can be regarded, prima facie, as being in the public interest. Consequently, if private individuals or organizations, desire to serve the public interest they determine whether any public policy exists in their field of endeavor and then try to further that policy. If no public policy is relevant to their activities, they are not concerned with the concept of public interest, politically defined, and must seek for other means of determining the social consequences of their actions. There is, of course, the possibility that an individual does not agree with the official interpretation of the public interest. His only remedy, in a democratic system, is to muster enough support for his viewpoint and either persuade the governmental body to change the policy or to vote for other representatives at the next election.

Flathman's decision to limit public interest to the political sphere has the advantage of making all questions of public interest referable to governmental policy. Public policies become the operational definitions of the public interest in the absence of evidence that government has violated its trusteeship by ignoring community values in the process of policy formulation. On the other hand, his

formulation has the disadvantage of being incomplete in the sense that the public interest is undefined in the areas where no public policies exist. It seems, however, that this defect can be remedied by adapting his conclusion to the requirements of a broader concept of public interest, as follows:

> "Public interest" is a general commendatory concept used in [justifying social behavior.] It has no general, unchanging, descriptive meaning applicable to all social decisions, but a non-arbitrary descriptive meaning can be determined for it in particular cases. This descriptive meaning is properly found through reasoned discourse which attempts to relate the anticipated effects of [social conduct] to community values and to test that relation by formal principles. (44, p. 82, adapted).

This reformulation provides a prescription for determining the descriptive meaning of the public interest in particular cases to any private individual or organization which might need such a guideline. The only difference is that the interpretation is not official and is open to criticism by both government and fellow citizens. It is incumbent on government to keep a watchful eye over all such private formulations of the public interest and to interfere only in those cases where it is deemed necessary upon an official investigation of the matter. Since unofficial interpretations of the public interest are more vulnerable than official interpretations, they do not constitute strong building material in a theory structure. Furthermore, when official interpretations do exist, private entities do not have much choice. Official policy may have to be observed. For these two reasons, the safer route appears to be the one that in matters of public interest assigns priority to official interpretations and definitions of the public interest, reserving private interpretation to those areas where public policies are nonexistent. This does not deny the right of any citizen who does not agree with public policy to follow constitutional means to advocate

his personal viewpoint. With these general considerations in mind, the present situation in the United States is now explored.

The Public Interest in the United States

The citizens of this country honor a constitution, including a "Bill of Rights," adopted by their forefathers and amended as and when deemed necessary by means of the machinery provided for in the Constitution itself. They have a continuing right to change their constitution and they put into authority representatives to govern the nation and interpret their interests in the spirit of the Constitution. This unalienable right was most vividly expounded by Thomas Jefferson in the Declaration of Independence:

> We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed, That whenever any Form of Government becomes destructive of these ends, it is the Right of the People to alter or to abolish it and to institute new Government, laying its foundation on such principles and organizing its powers in such form, so as to them shall seem most likely to effect their Safety and Happiness. [Emphasis added]

And in the preamble to the Constitution of the United States, it is acknowledged that the constitution should serve to express what the people of the country regard to be in their interest from time to time:

> We the People of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America. [Emphasis added]

It should, therefore, be fairly obvious that, although it is impossible to provide a descriptive meaning for the public interest which will transcend place and time, a nonarbitrary descriptive meaning has been

determined for it in the particular case of the United States. Should the rulers or the ruled have any desire to change this meaning, the machinery is available. Although this meaning is general and, to many, vague and imprecise, it offers the best yardstick available. The State and the Judiciary are, however, continuously engaged in a process of providing operational definitions to the concept of public interest or general welfare through policy formulation and legal decision. Public policies cover such matters as economic relationships; economic goals; social well-being, e.g., education, health, and recreation; defense; provision for the future; and international affairs. Support for this viewpoint is provided by many writers, including Leys and Perry who state it as follows:

> In its most general meaning, "public interest" may be used, as "general welfare" is used in the Preamble to the Constitution, to proclaim that government is a trusteeship, all of whose activities are properly directed to the benefit of the people or public. In such general use, the term posits a primary ideal of democratic government or, perhaps, of any legal order. This norm would seem to determine a formal relation between "the public interest" and "public policy": the objectives of public policy (and whatever promotes or hinders them) are matters of public interest (23, p. 10).

In another place they quote the views of four of their consultants and conclude:

> These quotations . . . point toward a procedural or constitutional doctrine about public interest, a doctrine to the general effect that public interest is specified and determined by the governmental processes by which policy is formed. . . . This procedural view of the public interest is widely held among political scientists (23, p. 26).

Thus, the public interest in the case of the United States and other countries with similar constitutions and ethical norms can be defined as:

1. Successful achievement of public policy as currently pursued

by the State, and

2. The right of both public officials and the people to strive for change in public policy according to their convictions and conceptions of what is in the interest of society.

Since accounting is concerned with the measurement and communication of economic data, accountants will concentrate on governmental economic policy for guidance on the official interpretation of the public interest in economic matters. Of course, accounting action also comes in contact with governmental policies in other areas, such as defense, public expenditure, and the administration of justice. These contact points cannot be ignored, but economic policy appears to be a rational starting point. In regard to economic policy the two-pointed question is: What is the current official formulation of the public interest on the economic plane, and is there any evidence available that government or the people desire any change in the present policy? A concise summary of current economic policy is given by R. A. Musgrave (37, pp. 107-114). It includes, *inter alia*:

1. Acceptance of the market mechanism as an impersonal allocator of resources. This implies that measures should be taken to enhance its efficient operation.
2. Acceptance of the fact that there are certain exceptions to the general rule, specifically with regard to natural monopolies, decreasing cost industries, public utilities, and the problem of externalities. Promotion of the public interest demands special treatment of these cases.
3. A free private enterprise system ensures maximum utilization

of scarce resources in the sense that private individuals are motivated to attain optimum efficiency. The corporation is the major kind of private business entity; corporate activity has, therefore, to be protected and promoted.

4. At the national level the public interest is served by stabilization, that is, stable economic growth, stable prices, and stable employment, with some permissible ranges of tolerance.
5. Narrowing of the extremely wide variations in income distribution, but retention of the system whereby remuneration is dependent on productivity, thus providing the needed motivation for improvement of personal skills and efficient use of skills and other resources.

For the accountant who is mindful of the public interest, the above public policies may serve as operational definitions of the public interest. The list is not exhaustive but it includes two of the fundamental institutions of capitalism - the competitive market and private enterprise. Should it be found that accounting is a significant factor in <u>these two areas</u>, a conclusion that the public interest concept is relevant to accounting theory and practice would be justified. Consequently, the present study is limited to the exploration of the role of accounting in the efficient operation of the market mechanism and in directing the private enterprise system.

Is any evidence available that forces are pressing for a change in the above formulation of the "economic public interest"? In response to this question it may be noted that observers like Galbraith argue that the market mechanism is "a snare and a delusion"(49). Others complain about the bigness and inequities of the establishment, consisting

of the large institutions created by virtue of, and under the protection of, the very Constitution which is supposed to protect the public interest. Should the views of these dissenters be considered in the formulation of public policy? The Constitution provides machinery based on democratic principles; this machinery enables a majority and even a strong minority group to have their views recognized by government. Thus, if their argument is persuasive enough it will in due course be reflected in governmental policy.

Diagramatic Presentation of "The Public Interest"

It should be noted that the present study deals with only a small section of the public interest. In order to delineate and clearly specify this area, Figure 3-2 has been prepared and is presented below. The official interpretation of the public interest with reference to the market mechanism - 3.1.1.1.1 in the diagram - is related to the functions of accounting in Chapter 4, and the official interpretation of the public interest with reference to private enterprise - 3.1.1.1.2 in the diagram - is related to the functions of accounting in Chapter 5.

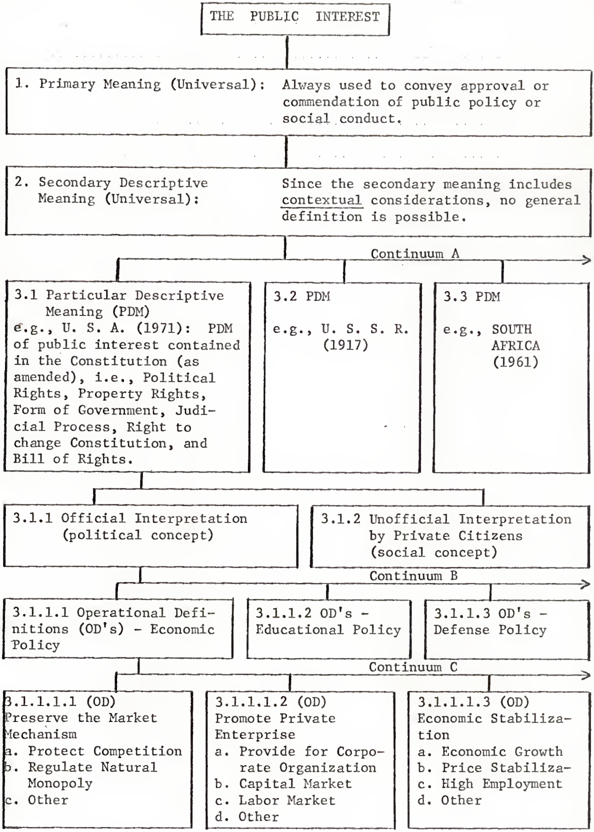

Figure 3-2. Diagramatic Presentation of the Public Interest

Summary

The meaning of a concept can be defined constitutively with reference to other concepts and symbols. A constitutive definition has the disadvantage of not being verifiable by common observation, but serves a purpose as a guide to the formulation of operational definitions which establish meaning by stipulating the operations by which questions concerning the concept ought to be answered. An inquiry aimed at finding the constitutive meaning of public interest reveals only two properties of the concept that are general enough to justify their acceptance as a general description of the concept. These two elements are:

1. The concept is used to commend public policy or social conduct, and
2. Its meaning in a particular case depends on the values of the particular community.

"Individual interest," which is itself a complex concept deserves an important place in the definition of public interest, particularly the elements other-regarding interest and non-selfish self-regarding interest. The admission of self-interest as an element in a particular definition of public interest requires a number of formal principles or norms to handle the situation of interest-conflict. These norms are basically ethical, but if already established by a society they become descriptive ethical propositions and, thus, are acceptable for inclusion in a particular descriptive meaning of the public interest. The ethical standards of the people of the United States are contained in the Constitution and in judicial pronouncements. The particular descriptive meaning is made operational through the process of public policy

formulation, e.g., economic policy, educational policy, and defense policy. Since competitive markets and the private enterprise system are two cornerstones of a capitalistic economy and since accounting information appears to be particularly relevant to their efficient functioning, the official economic policies in relation to these two institutions are selected as operational definitions of the public interest for purposes of the present inquiry. Future research might be directed towards determining any relationships between other public policies and accounting and towards expanding the constrained definition of the public interest adopted in this study to include, if possible, also non-political interpretations.

CHAPTER 4

ACCOUNTING AND THE MARKET MECHANISM IN TERMS OF OPERATIONAL DEFINITION NO. 1 OF THE PUBLIC INTEREST

Certain basic economic decisions have to be taken in every community which seeks to attain an efficient allocation of economic resources. These include:

1. What to produce.
2. How to produce it.
3. How to distribute the output produced.

In a fully planned economy this function is performed by central planners, who are confronted with the problem of determining consumer values and preferences in the absence of a market which acts as indicator. Severe shortages or surpluses of particular commodities may suggest "wrong" decisions, at least in terms of consumer desires. This is an *ex post* revelation. The problem is to find an *ex ante* or, even better, a "running" indicator of consumer preferences to guide production.

In a capitalistic economy the market, by performing the role of running indicator, handles the planning. Since this is the type of economy chosen for the present study, an examination is necessary to determine how the market performs its complicated task. This process is described briefly before exploring the role of accounting information in the efficient functioning of the mechanism.

It is assumed that governmental economic policy is formulated in

accordance with the official interpretation of the public interest on the economic plane. One accepted interpretation of the public interest at this level is that economic policy should be aimed at the economizing of the country's scarce resources. Thus, a theory to guide the optimal allocation of resources is required. The formulation of such a theory has for many years been the object of Welfare Economics. Various theories have been developed, all of them imperfect to some extent. The main problem is the difficulty of measuring and comparing personal values and preferences. Reasonable consensus exists, however, as to the theoretical requirements for bringing about a welfare optimum or "Pareto optimum" (named after the economist Vilfredo Pareto who originally formulated the requirements of criteria).

The Pareto Criteria for Welfare Maximization

A welfare optimum can be described as "a situation in which nobody can move to a position which he prefers without moving somebody else to a position which is less preferred." (50, Vol. II p. 12), or viewed from another angle: "the welfare of the community cannot be said to be maximized if it is possible, by changing the existing resource allocation or distribution of output among members of the community, to increase the satisfaction of some members without reducing the satisfaction for any other members (51, p. 138). The general idea is clear, but how can such an optimum situation be created? To this end, several economists have presented lists of conditions to be met. Melvin Reder, for instance, presents a list of seven conditions (52, pp. 21-38); I. D. M. Little gives four, with sub-divisions (53, pp. 129-151); and Douglas Needham

three (51, p. 138). These conditions were also set out in detail earlier by such well-known economists as J. R. Hicks, Oscar Lange, and A. P. Lerner. According to Reder, it is Hicks who "baptized" them as "marginal conditions of maximum welfare" (52, p. 21). A concise summary of the conditions is presented by Professor Milton Z. Kafoglis, as follows:

> It is possible to derive a series of marginal conditions which must be satisfied if this optimal situation is to be achieved. The derivation of these conditions involves a considerable amount of technical, but generally accepted, analysis. Melvin Reder provides a lucid and complete graphical treatment in which he sets forth seven marginal conditions of maximum welfare. The first marginal condition determines an optimum of exchange. The second, third, and fourth conditions relate to technical productive efficiency, while the fifth specifies the relationship between production and consumer preferences (the optimal direction of production). Optimal relationships between leisure and product are posited by the sixth condition, and the seventh denotes optimal time relationships (lending and borrowing).
>
> When stated in terms of cost and price, the optimum requires the satisfaction of two conditions. (1) Price must equal marginal cost, and (2) total cost of the optimum output must be at a minimum. The first condition ensures an optimal division of resources among different goods (answering the question: How much of each good to produce?), while the second ensures the optimum conbination of factors in each productive unit (answering the question: How to produce the optimal output?). The second condition is satisfied when production is adjusted so that the marginal product of each factor is equal to the price of the factor. This is no different than saying that production should be so adjusted that the single pricing principle - price equal marginal cost - emerges from the marginal conditions of maximum welfare. Whereas the marginal conditions of maximum welfare merely describe the optimal situation, marginal cost pricing provides, in theory at least, a normative standard as well as a prescription. Under conditions of perfect competition, infinite divisibility and, in the absence of external economies, all of the marginal conditions are satisfied, and the universal equality of marginal cost and price is achieved. This is indeed the welfare characteristic of perfect competition that makes it so attractive as a standard of economic efficiency (54, p. 6).

He also points out that, in addition to the "very significant practical difficulties that would have to be surmounted before marginal cost

pricing could become a reality," there are qualifications of equity (income distribution) and social value (externalities). Although these last two phenomena are extremely important for public policy, they are accepted as given in order to simplify the study of the welfare criteria under conditions of perfect competition. The standard methodology of using the perfect competitive market as model for purposes of analysis, subject to possible modifications to allow for the existence of a mixed economy where appropriate, is utilized.

Since the purpose is to determine, step by step, how accounting information might possibly affect the functioning of the market mechanism, three aspects of market performance are treated separately, viz.:

1. The optimum of exchange (distributive efficiency).
2. Technical productive efficiency.
3. Optimal direction of production (allocative efficiency).

In his work, Economic Analysis and Industrial Structure, Douglas Needham provides a fairly simple algebraic analysis of each of these three marginal conditions in a manner that makes them particularly susceptible to utilization as an analytical tool in an inquiry into the relevance of accounting for the functioning of the market mechanism. The following presentation, although somewhat extended, is based mainly on Needham's analysis.

Distributive Efficiency

Regardless of what is produced or how efficiently it is produced, there is the question of how any particular aggregate output should be allocated among members of the community in order to maximize welfare.

> In order that a particular aggregate output of products be distributed optimally among members of the community, it must be impossible, by re-allocating the output among consumers, to make someone better off without making someone else worse off. This requires that the ratio of marginal utilities of any two products be the same for all consumers (54, p. 6).

Although marginal utility itself is subjective and cannot be measured, a ratio of marginal utilities – the marginal rate of substitution (MRS) – can be measured. The MRS expresses an individual consumer's relative evaluation of one additional unit of a commodity in terms of another commodity. The rule for distributive efficiency can be written as:

$$\frac{MU_A^1}{MU_B^1} = \frac{MU_A^2}{MU_B^2} = \frac{MU_A^3}{MU_B^3} = \ldots = \frac{MU_A^n}{MU_B^n}$$

where MU = Marginal Utility, the subscripts A and B refer to two different products and the superscripts 1, 2, 3 . . . n refer to different individuals. How can this optimum position be achieved?

Assuming the consumer to be rational, he wants to maximize his satisfaction to be derived from all available goods, subject to certain constraints such as income, prices, and availability. To achieve this he distributes his income over the available goods and services such that the marginal utility of every good consumed is proportional to the price of the good, i.e.,

$$\frac{MU_B^1}{MU_A^1} = \frac{P_B^1}{P_A^1} \qquad \ldots\ldots\ldots\ldots\ldots(1)$$

where P = price of the product.

He is thus operating on the highest indifference curve tangent to his budget line.

If individual no. 2 is also rational, he too buys commodities in such quantities that for him the ratio of marginal utilities of any two goods is equal to the price ratio of the goods, i.e.,

$$\frac{MU^{2}_{B}}{MU^{2}_{A}} = \frac{P^{2}_{B}}{P^{2}_{A}} \qquad \text{...............} \quad (2)$$

In a competitive market economy the long-run price for identical products is the same for all consumers, i.e.,

$$P^{1}_{B} = P^{2}_{B} \text{ and } P^{1}_{A} = P^{2}_{A} \qquad \text{...............} \quad (3)$$

$$\frac{P^{1}_{B}}{P^{1}_{A}} = \frac{P^{2}_{B}}{P^{2}_{A}} \qquad \text{...............} \quad (4)$$

$$\frac{MU^{1}_{B}}{MU^{1}_{A}} = \frac{MU^{2}_{B}}{MU^{2}_{A}} = \frac{MU^{3}_{B}}{MU^{3}_{A}} = \ldots = \frac{MU^{n}_{B}}{MU^{n}_{A}} \qquad \text{...............} \quad (5)$$

This is true for all goods and services so that the competitive market system can claim the capability of distributing total output in an impersonal manner such that all consumers enjoy Pareto optimality in regard to distribution of output.

The ratio of marginal utilities of two goods indicates the ratio in which the consumer is willing to substitute the two goods for each other. For instance, if

$$\frac{MU^1_B}{MU^1_A} = \frac{2}{1} \qquad \text{...............} \quad (6)$$

it means that he is willing to give up 1B in exchange for 2A. This can be written as

$$\frac{MU^1_B}{MU^1_A} = \frac{A}{B} = \frac{2}{1} = MRS_{BA} \qquad \text{...............} \quad (7)$$

With the price ratio included, the complete condition for distributive efficiency is, therefore:

$$\frac{P_B}{P_A} = \frac{MU_B}{MU_A} = \frac{A}{B} = MRS_{BA} \qquad \text{...............} \quad (8)$$

Technical Efficiency

The welfare answer to the question "how to produce," is: "as efficiently as possible," or more technically:

> In order that a given combination of products be produced as efficiently as possible, it must be impossible to produce the same combination of products by using fewer productive resources or inputs. This requires that the ratios of marginal physical products of any two inputs be the same in the production of all different commodities produced (51, p. 139).

The rule for technical productive efficiency (equality of the ratios of marginal physical products of inputs) can be written as:

$$\frac{MPP^{L}_{B}}{MPP^{K}_{B}} = \frac{MPP^{L}_{A}}{MPP^{K}_{A}} = \ldots\ldots = \frac{MPP^{L}_{N}}{MPP^{K}_{N}} \qquad \ldots\ldots\ldots\ldots\ldots \quad (9)$$

where MPP = marginal physical product of inputs, L = input (say, labor), K = input (say, capital), A, B, . . . , N different outputs of goods and services.

Given certain assumptions and constraints (e.g., that the *entrepreneur wishes to maximize profits*, that he is faced with fixed prices for different inputs, a given state of technology, and a limited budget), the entrepreneur chooses the point of production where his isoquant line is tangent to his budget line, i.e., where

$$\frac{MPP^{L}_{A}}{MPP^{K}_{A}} = \frac{P^{L}_{A}}{P^{K}_{A}} \qquad \ldots\ldots\ldots\ldots\ldots\ldots \quad (10)$$

Other producers behave in the same manner, under the same assumptions, so that

$$\frac{MPP^{L}_{B}}{MPP^{K}_{B}} = \frac{P^{L}_{B}}{P^{K}_{B}} \qquad \ldots\ldots\ldots\ldots\ldots \quad (11)$$

Under pure competition the price of any particular input should be the same for all producers. The subscripts in the price ratios are thus superfluous and may be dropped, i.e.,

$$\frac{P^L_A}{P^L_A} = \frac{P^L}{P^K} = \frac{P^L_B}{P^K_B} \qquad \ldots\ldots\ldots\ldots\ldots \quad (12)$$

$$\frac{MPP^L_A}{MPP^K_A} = \frac{P^L}{P^K} = \frac{MPP^L_B}{MPP^K_B} \qquad \ldots\ldots\ldots\ldots\ldots \quad (13)$$

This can also be written as

$$\frac{MPP^L_A}{MPP^L_B} = \frac{MPP^K_A}{MPP^K_B} \qquad \ldots\ldots\ldots\ldots\ldots \quad (14)$$

Pareto optimality in production is thus achieved in a competitive market economy due to the fact that only one, market-determined, price exists for every input and this price is considered by all producers in their decisions about input combinations.

Allocative Efficiency

Allocative efficiency is achieved when an optimal allocation of resources among different alternative combinations of products is secured. The marginal rate of substitution (MRS) of one product for another is the rate at which every member of the community is willing to exchange one

commodity for another. The marginal rate of transformation (MRT) is the rate at which producers can transform one product into another by reallocating resources between the two goods. The rule for optimal resource allocation is that for any two commodities produced and consumed the marginal rates of substitution and transformation must be equal, i.e.,

$$MRS_1 = MRS_2 = \ldots = MRS_n = MRT \qquad \ldots\ldots\ldots\ldots\ldots \quad (15)$$

The ratio of marginal physical products of inputs of productive resources indicates the ratio in which a producer would be able to switch production from one commodity to another. For instance, if

$$\frac{MPP^{L}_{A}}{MPP^{L}_{B}} = \frac{MPP^{K}_{A}}{MPP^{K}_{B}} = \frac{2}{1} = \frac{A}{B} = MRT_{BA} \qquad \ldots\ldots\ldots\ldots \quad (16)$$

he is able to produce 2 more A by cutting the production of B by one unit.

The question still remains whether or not the producer will be influenced by the price system to produce the goods demanded in the proportions demanded by consumers. According to the economic <u>theory of profit maximization</u> the pure competitor produces at the level where, for him, marginal cost (MC) equals marginal revenue (MR) which in turn is equal to price since only one competitive price exists for all identical goods, regardless of the quantity offered by the individual producer, i.e.,

$$P_A = MR_A = MC_A \qquad \ldots\ldots\ldots\ldots\ldots\ldots \quad (17)$$

$$P_B = MR_B = MC_B \qquad \ldots\ldots\ldots\ldots\ldots\ldots \quad (18)$$

Given that technical efficiency is achieved, it follows from (10) that

$$\frac{P^L_A}{MPP^L_A} = \frac{P^K_A}{MPP^K_A} \qquad \ldots\ldots\ldots\ldots\ldots \quad (19)$$

But, $$\frac{P^{LK}}{MPP^{LK}} = MC \qquad \ldots\ldots\ldots\ldots\ldots \quad (20)$$

$$\therefore \frac{P^L_A}{MPP^L_A} = \frac{P^K_A}{MPP^K_A} = MC_A \qquad \ldots\ldots\ldots\ldots\ldots \quad (21)$$

and $$\frac{P^L_B}{MPP^L_B} = \frac{P^K_B}{MPP^K_B} = MC_B \qquad \ldots\ldots\ldots\ldots\ldots \quad (22)$$

$$\therefore \frac{P_B}{P_A} = \frac{MC_B}{MC_A} = \frac{MPP^L_A}{MPP^L_B} = \frac{MPP^K_A}{MPP^K_B} \qquad \ldots\ldots\ldots\ldots\ldots \quad (23)$$

Thus, given the stated assumptions, allocative efficiency is achieved in a competitive market economy by virtue of the fact that only one input price exists for each productive input and only one price exists

for all identical units of output.

Equations (8), (15), (16), and (23) can now be combined to illustrate a complete Pareto optimum equilibrium, as follows:

Distributive Efficiency	Allocative Efficiency	Technical Efficiency

$$\frac{P_B}{P_A} = \frac{MU_B}{MU_A} = \frac{\Delta A}{\Delta B} = MRS_{BA} = MRT_{BA} = \frac{\Delta A}{\Delta B} = \frac{MPP^{LK}_{A}}{MPP^{LK}_{B}} = \frac{MC_B}{MC_A} = \frac{P_B}{P_A}$$

This formula constitutes the model of a perfectly competitive market economy where commodities are produced in the most efficient manner and in the combinations desired by the people (given present income distribution). The accounting environment is, of course, a mixed economy and market prices are not perfect due to factors such as imperfect information, monopolistic tendencies, and the existence of externalities. These aberrations are, however, regarded as abnormal in most capitalistic economies; public policy is usually aimed at reinforcing the competitive market and curtailing monopolistic behavior. The assumption that accounting activity takes place in a fairly competitive market economy is, therefore, considered to be reasonable.

The Role of Accounting Information in the Achievement of Paretian Optimality

One of the main requirements for the existence and success of markets is the availability of information including financial as well as non-financial information, either of which may be more important at different times and under varying circumstances. Financial information is usually extracted from accounting records, either directly or from a source that utilizes and rearranges prior accounting information. It may be a fruitful exercise to examine the market mechanism more closely and to inquire just how accounting information is used in the different decision-making processes.

Guided by the equilibrium model, presented above, the examination is broken down into three steps. The influence of accounting on the achievement of

1. distributive efficiency;
2. technical efficiency; and
3. allocative efficiency

is explored separately. First, however, one general observation may be made. "When stated in terms of cost and price," according to Professor M. Z. Kafoglis, "the optimum requires the satisfaction of two conditions.

1. Price must equal marginal cost and
2. total cost of the optimum output must be at a minimum"

(54, p. 6).

These are conditions for profit maximization. Interestingly enough, profit maximization, in this sense, leads to the achievement of maximum welfare by virtue of the fact that resources are employed as economically as possible and production is limited to demand. Therefore, insofar as

the accounting process can generate the type of information that enhances profit maximization under conditions of perfect competition, it is at the same time enhancing the achievement of optimum welfare. This suggests that accounting measurement rules must be aimed at providing the type of information that aids rational action in present and future markets, rather than providing solely historical data.

The position is obviously different under monopolistic conditions. Profit maximization in this case, where price is above marginal cost, is contrary to the welfare requirements. The service that accounting can render here is probably limited to measuring monopoly profits as accurately as possible and to reporting it frankly. This will attract the attention of both government and potential competitors which may lead monopolistic and oligopolistic industries or firms "to behave more competitively."

With these general observations in mind, the market and the role of accounting is now considered in more detail.

Distributive Efficiency

To achieve this ideal, the ratios of marginal utilities of all products must be equal for all consumers. This is achieved in a competitive market economy by virtue of the fact that only one price exists for identical commodities. Does accounting play any role here? Under the assumption of pure competition all prices for identical commodities are equal in the long run regardless of accounting calculations. Those sellers who over-estimate demand or probable profits may have to suffer losses because they are not able to charge higher prices than the market is willing to determine.

This may, however, not be true in the short run. Due to imperfect information, immobility, and other factors some sellers may be able to sell at higher prices. The probability that this may happen is increased by the existence of diverging costs revealed by the accounting system of each firm, due to different cost structures as well as the application of different accounting principles. Production costs normally are different for individual firms in the short run. Differences may, however, be accentuated by different accounting procedures, for instance, depreciation methods, allocation of long-term intangible costs, special tax allowances, price and price level changes. Where firms are led by unwarranted cost calculations to charge different prices for identical commodities in the short run, the requirement of one price is violated and distributive efficiency not achieved. While this is, in the first place, due to imperfections in the market, accounting is not free of all blame in those cases where temporary high prices are inspired by artificially inflated costs or where costs are understated due to unrealistic valuation of cost expirations.

There are also economists like John Kenneth Galbraith and who maintain that prices are no longer determined by the market in many instances, but by the powerful giant producers. The smaller producers willingly accept the prices of the price leaders. This may result in one price for a particular commodity which is, however, excessive and although it does not violate the condition for distributive efficiency, it causes inequitable income distribution and violates allocative efficiency. But this problem is for government, not accounting, provided the accountant discloses the super profits realized by these businesses.

In brief, distributive efficiency is affected by so many other

factors that the ephemeral influence of accounting information can almost be disregarded. Only a perfect market or price control can really provide the single price per commodity required for distributive efficiency. In a planned economy a single price can easily be set. However, especially in the case of necessities, there is no indication of the extent to which subjective needs are satisfied in the absence of an uncontrolled price system.

Technical Efficiency

To achieve technical efficiency in the entire economy two conditions must be met:

1. Each producer must use a least-cost combination of inputs to produce his products, i.e.,

$$\frac{MPP^{L}_{A}}{MPP^{K}_{A}} = \frac{P^{L}_{A}}{P^{K}_{A}}$$

2. The ratio of marginal productivities of any two inputs must be the same in the production of all different commodities produced by all producers, i.e.,

$$\frac{MPP^{L}_{A}}{MPP^{K}_{A}} = \frac{MPP^{L}_{B}}{MPP^{K}_{B}} = \ldots\ldots = \frac{MPP^{L}_{N}}{MPP^{K}_{N}}$$

In order to enable the individual producer to know whether or not he is using the least-cost combination of two inputs, e.g., labor and capital,

he needs a variety of information, including the cost of a unit of capital and the cost of a unit of labor. The cost of a unit of labor may present some difficulty. Cash wages payable to employees are known directly, but the cost of fringe benefits may constitute a significant part of the total labor cost. Labor cost usually includes the cost of pension plans and capital equipment used for recreation and other purposes. Actuarially, the cost of pension plans can be estimated fairly accurately. Where this is not done, however, labor cost may be grossly misstated. Capital equipment used to provide facilities to employees may have been aquired long ago and may be understated in terms of current prices. Consequently, the cost of providing the facilities may be seriously underestimated. The result of such errors, is a bias in favor of using labor where capital might have been more appropriate. The error as far as capital facilities are concerned may be partly compensated for, however, due to a corresponding misstatement of the cost of using capital for production and general administration. Experienced businessmen can be assumed to be aware of such deficiences in the accounting records and may be making at least mental allowance for it in their resource allocation decisions. On balance, therefore, the cost of labor, although somewhat distorted by current accounting methods, is perhaps not so grossly misstated as to affect resource allocation significantly.

In regard to the cost of using capital the position is much more complicated. Although much progress has been made in the last ten to fifteen years in the cost of capital area, especially in budgeting for new investment, the real cost of using existing capital is not easily discernible from present accounting records due mainly to the investment

in capital resources not being stated in meaningful terms. It is usually a potpourri of unallocated historical cost, not adjusted for any price or price level changes. Often these capital resources are overdepreciated (for tax purposes) and stated net of "investment credit" tax allowances. The argument may again be offered that experienced businessmen make allowances for these discrepancies between book values and real values, but this amounts to crediting them with a super-intellegence, enabling them to make mental adjustments where trained specialists are baffled.

In view of the foregoing, it is fairly clear that entrepreneurs cannot be certain about the cost of a major input, capital. Even though engineers might be able to estimate the marginal physical product of capital, accountants may have trouble in translating this into marginal productivity since the cost of the input is uncertain. A high probability exists, therefore, that many firms do not use least-cost combinations of productive resources simply because the information is not available from the accounting records. If this be true, accounting, through failure to measure the cost of capital satisfactorily, is partly to blame for the failure to achieve optimality in resource allocation.

The second condition for the achievement of technical efficiency (the ratios of the marginal products of any two inputs must be the same in the production of all different commodities produced by all producers) is now considered. As stated above, this is accomplished in a competitive market economy by virtue of the fact that, first, all producers employ least-cost combinations of inputs and, second, only one price exists for each input of the same grade. Doubt has already been expressed regarding the present ability of the accounting system to

provide the information required for the achievement of least-cost combinations of inputs. To that extent the attainment of technical efficiency is, therefore, jeopardized. A further question arises now. What is the role of accounting information in the realization of the ideal of one price for all similar inputs?

The immediate response of believers in the competence of the market is that the role of accounting is negligible. The prices of land, labor, and capital are determined in the property, labor, and capital markets; when these markets are functioning properly the ideal of one price for the same grade of input is realized. This statement is probably true for the long run, but everybody is aware of the wide short-run oscillations that occur around the long-run price. These variations are usually attributed to imperfections of the market caused to a considerable extent by misinformation or lack of information. The capital market is particularly dependent on accounting information. Although some observers express doubt that the capital market is much influenced by published financial reports, the majority of scholars still believe that these reports are not ignored by the investing public. Not only does common sense revolt against the idea that society would persist in spending astronomical amounts on the production of information that nobody uses,* but empirical evidence is also available that these reports are in fact included in the determinants of security prices and thus in the determination of the cost of capital (55, 56, 57, 58). Typically,

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* In this regard R. J. Chambers points out:

Putting this information on record and distributing it is a

empirical researchers find that, although many other variables are considered by investors in their decisions, accounting information is always one of the factors. This is not surprising in view of the impossibility of making a rational decision about the probable value of a share of stock with no indication at all of past, and/or probable future, cash inflows in connection with the stock. The probable size of these flows is determined upon due consideration of realized and expected net income and other performance indicators which are revealed by the accounting process.

The discussion so far is based on the assumption that the input price of capital or the cost of capital is related to the market prices

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> costly business. Take any selection from today's company reports. A vast amount of expensive time must go into the preparation of financial statements, the accompanying text, and illustrations, and a deal of money into the printing and distribution of reports. Much expensive time goes into the preparation of statements to be registered with the SEC. Much expensive time is spent by analysts in analyzing and by executives explaining to analysts, what companies are doing, and how, and how well. Much time is spent by the information services in digesting financial reports and by hosts of other firms and persons in interpreting these reports. Why all these costs and why is the publication of information mandatory? (59, p. 2)

Some indication of the vast amounts involved in the creation and distribution of accounting information comes from a Fortune article (60, p. 96). According to this source, the annual revenues of the two largest firms of the "Big Eight," Peat, Marwick, Mitchell & Co. and Arthur Anderson & Co., are \$270,000,000, and \$200,000,000, respectively. And auditing represents only a tiny fraction of the total costs of financial measurement and communication.

of securities and that the latter are in turn influenced to some extent by reported accounting information. Insofar as different firms employ divergent accounting rules and procedures, they cause variations in the price of capital that cannot be justified by the circumstances. Consequently, the condition of one price for all similar inputs is violated and technical efficiency is not achieved. It may be argued, however, that the cost of capital formula in terms of which returns are related to the market price of stock is not widely used by firms in the real world. Thus, no harm is done by the possibility that stock prices may reflect erroneous accounting measurements. But if these firms do not employ one of these market-related formulas, how do they figure the input price of capital? Perhaps a "satisfactory" or minimum return on book value? In the light of the well-established fact that book values are poor value-indicators and vary haphazardly in significance from firm to firm, such a practice would be disastrous for the achievement of technical efficiency. There would be almost as many prices for capital as there are firms. If businessmen were in fact so naive as to use the latter method to price capital, an almost intolerable burden would be placed on accounting to produce "realistic book values" in an endeavor to make the cost of capital for similar firms comparable and so to approach the ideal of one price for all similar inputs.

The upshot of the foregoing arguments is that whether investors base their valuations of stock prices on accounting reports, or business firms themselves base their determination of the price of capital on accounting-determined book values (in exceptional cases), accounting information is relevant to the accomplishment of Pareto optimality with regard to technical efficiency.

There is still another consideration concerning the input, capital. Capital is partly used to buy productive assets such as property, plant, and equipment. The cost of using these assets includes the value expirations as determined for accounting purposes. Technical efficiency in the Paretian sense would require that all firms use the same "ideal formula" for calculating depreciation, i.e., a formula which discloses the "true" economic cost of using the asset. This ideal, however unattainable, may perhaps be approached under certain conditions, for instance, by adjusting historical cost for definite trends in specific prices and the price level and by objective attempts to measure economic user-cost, free of subjective motives such as tax or stock market considerations.

At this junction an important fact must be emphasized. The Paretian criteria stipulate one price for all similar inputs, not a "just price" or "accurate price" or "reasonable price." Even if this one price were determined and promulgated by government, it would serve some purpose. How can such uniform pricing be achieved in a free enterprise market economy? The answer is, "it cannot," but one way of approaching it is the use of market prices regardless of whether they represent "coincidence of agreement" or "consensus of value" (61, p. 33). If service potential expirations were always valued at current market prices, which are fairly uniform for similar goods in a market economy at a given point in time, and based on objective assessment of facts and expectations, depreciation charges (a significant cost component) would be more comparable within as well as across industry borders. Consequently, reported income would to that extent be more comparable, thus tending to improve security valuations and consequently cost of capital calculations based on market prices of corporate securities.

To summarize, two conditions for the achievement of technical efficiency are that each producer should use a least-cost combination of inputs and that the ratios of marginal productivities of any two inputs must be the same in the production of all different commodities produced by different producers. Factor costs are determined partly by utilizing accounting information. The cost of capital is particularly heavily influenced by accounting practices and procedures. In order to achieve least-cost combinations the entrepreneur has to rely on the accounting process to provide "correct" factor costs. The probability that specific factor costs are sometimes overstated and sometimes understated does not solve the problem. In both cases resources are misallocated. Calculations of marginal productivity require input and output prices to be multiplied with marginal output. Ratios of marginal productivity are comparable only if uniform market prices are used in the accounting process. Thus, market actions and accounting actions are seen to be inextricably intertwined. The conclusion that accounting activity is relevant to the achievement of technical efficiency appears, therefore, to be justified.

Allocative Efficiency

A prerequisite for the achievement of efficiency in the allocation of resources to the production of different commodities is that technical efficiency in production has been accomplished. This, added to the assumed existence of uniform input and selling prices in a competitive market economy, leads producers to supply exactly the goods required by consumers in the proportions demanded. The underlying theory rests on the assumption that firms are able to calculate the marginal productivities

of different input factors as well as the marginal costs and marginal revenues associated with different levels of production. The responsibility for calculating physical marginal inputs and outputs rests with engineers and need not be overly complicated. The burden of translating these physical quantities into monetary values falls on the shoulder of the accountant.* He has to "price"them. Outputs are readily priced at expected market selling prices so that different accountants and firms will be in substantial agreement as to the probable values of their outputs.

Input prices may, however, vary widely. Inventories of raw materials and finished goods acquired at various prices may have been accumulated over a period of time. Many inventory-pricing procedures are available according to which the same commodity's input value may be stated at a price that prevailed in the distant past, or at an average or standard price, or at a current market price. Similar problems arise in connection with the valuation of long-term asset expirations as indicated earlier. These are the two main forces that oppose the

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* The term "marginal" as used in marginal cost, marginal revenue, and marginal productivity is an accepted economic concept used for analytical purposes. The notion is, however, not foreign to accounting since it is used in areas such as variable or marginal costing (also referred to as direct costing), in cost-volume-profit analysis, in break-even analysis, and for planning decisions in general. Thus, although marginal analysis is primarily an analytical tool, it can also be a useful practical tool. The practical application is necessarily crude in comparison with theoretical analysis where fine divisibility can be assumed regardless of real world correspondence. While this limitation to the application of marginal analysis in accounting practice is acknowledged, it is submitted that the economic model of an efficient market mechanism based on the marginal conditions stated above is applicable to accounting <u>theory</u> at least.

achievement of uniform input prices which is a condition for the achievement of allocative efficiency. To these can be added the controversial aspects concerning the treatment of income taxes and tax allowances and the problems of allocation to particular periods of intangibles; e.g., research and development costs, advertising, patents and trademarks.

Once more, it is important to note that the Paretian criterion is one input price for identical or similar productive inputs, not a fair price, or right price. How can such uniformity be attained in a free enterprise system short of governmental regulation? Again, the most rational solution appears to be the use of market prices provided a fairly well-organized market exists for the particular commodity or capital good to be valued. The proponents of the Paretian criteria claim that a competitive market economy can succeed in allocating the productive resources and production of an economy effectively, provided that certain conditions are met, one of which is the existence of uniform input prices for factors of production. They claim further that the market itself provides these uniform input prices as a result of free competition. These market prices are the values which the free enterpriser is supposed to consider in his decision-making process. It is obvious that, if this be true, he will be very much aided if these same values were incorporated into the system by the accountant. Otherwise, he would have to adjust accounting generated data for the degree of divergence from market-generated data. This feat may be beyond his capability. On the other hand, the accountant who is a trained specialist in the arrangement of financial data may be better capable of incorporating the required information into the system. This would have the

added advantage that the entrepreneur as well as his judges would be basing their decisions and opinions on the same data.

The Significance of Market Prices

The relevance of market prices to managerial decisions and the consequent need for accounting recognition of such prices were quite clear to W. A. Paton in 1922, when he wrote:

> If the tendencies of the economic process as evidenced in market prices are to be reflected rationally in the decisions of business managers, efficient machinery for the recording and interpreting of such statistics must be available; and a sound accounting scheme represents an essential part of such a mechanism (13, p. 8).

Accounting scholars have long been, and still are, aware of the effect of accounting information on the economy and specifically on resource allocation. In addition to Paton's view, quoted above, a number of quotations from the accounting literature have been presented in Chapter I to illustrate this point. Those authors are, however, mainly concerned with the flow of capital into the "right firms," i.e., those firms that serve the public interest, apparently by producing what the public wants and producing it most efficiently. However, at least one team of writers, the business economists, Edgar O. Edwards and Philip W. Bell, refer to the Paretian optimality rules:

> Evaluation by both insiders and interested outsiders provides the key to the successful functioning of a private, free enterprise economy. If the task is performed effectively, resources will be allocated efficiently. (We are here thinking of the term 'efficiency' in the economic sense associated with Paretian optimality.) (62, p. 271)

In their study, Edwards and Bell come to the conclusion that market prices provide the relevant input data for accounting purposes. However,

they do not derive this conclusion from the Paretian rules, but rather from the nature of the business decision-making process.

From the foregoing discussion, it appears that:

1. The data generated by the accounting process are recognized and utilized as information inputs by the market.
2. Since uniform, market-determined input prices are relied upon in a market economy to lead enterprisers to efficient resource allocation, incorporation of these market-determined prices in the accounting system appears to be justified.

This circular flow of financial information between firms and markets can be illustrated as follows:

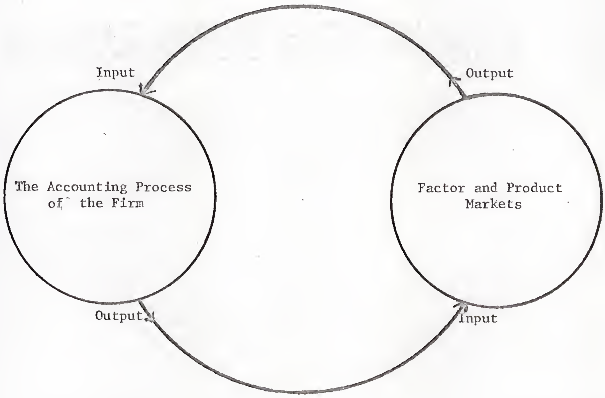

Figure 4-1. Circular Flow of Financial Information Between Firms and Markets

An appropriate illustration of the importance of recognizing this interaction between the accounting process and the factor markets is the unfortunate experience of the railroad industry at the turn of the nineteenth century (63, pp. 336-352). By neglecting to recognize adequate amounts of depreciation on its fixed assets it overstated income initially, which led to unjustified increases in railroad security prices, a heavy flow of capital to these companies, low apparent cost of capital, overexpansion, and finally, failure. If depreciation rates had reflected "realistic" assessments of asset expirations in terms of expected replacement costs in current markets, the reported incomes would have provided better guidance to investors. Stock prices would in turn have provided a more realistic basis for the determination of cost of capital, i.e., the price of the input, capital. The interaction is clear. Income and other performance indicators which are accounting outputs are input measures to the stock market, and stock prices which are factor market outputs are input measures to the businessman's decision process and thus, preferably to the accounting process also.

The following hypothetical case could illustrate the interaction between the accounting process and the product market. The demand for bicycles increases. Since supply is fixed in the short run, both retail and wholesale prices increase. Two accounting procedures are available to traders. They report the full difference between the new, higher selling prices and their original cost as (gross) profit, or they value cost of sales at the new increased input prices. If they follow the former procedure, the temporary high profit rate attracts more manufacturers to the market or induces present manufacturers to increase production sharply. Overproduction may follow. If they follow the latter

procedure, increased profits due to increased turnover will be reported but not necessarily higher profit rates. Consequently, the market is stimulated to increase production moderately and the danger of overproduction is diminished accordingly. Again, the profit rate put out by the accounting process is an input datum to the market. This datum is improved if prices put out by the market are put into the accounting process in the production of the information needed by the market.

If the assumption that the use of market prices to value asset expirations will reduce the incidence of temporary overproduction is valid, such action would enhance economic stability. Short-run profits and losses would oscillate less vigorously around long-run profits which would not only limit the wasteful usage of resources seen from a national viewpoint, but would also reduce the hardship suffered by many individual producers seen from the personal viewpoint.

It is interesting to compare the foregoing discussion with a statement made almost half a century ago by W. A. Paton. He wrote:

> To put the matter in very general terms, accounting, insofar as it contributes to render effective the control of the price system in its direction of economic activity, contributes to general productive efficiency, and has a clear-cut social significance, a value to the industrial community as a whole (13, p. 9).

CHAPTER 5

THE FUNCTIONS OF ACCOUNTING IN A FREE ENTERPRISE SYSTEM IN TERMS OF OPERATIONAL DEFINITION NO. 2 OF THE PUBLIC INTEREST

The purpose of this chapter is to inquire into the role performed by accounting in a free enterprise economy. Recognizing that significant differences exist among various capitalistic economies, a specific economy is chosen, viz., that of the United States. Research is usually undertaken with a view to improve future action. In order to map the course of future action, the present position or situation must at least be known. But this raises the question of whether an inquiry might also be aided by seeking some historical perspective. In his highly regarded work, The Idea of History, R. G. Collingswood includes a section entitled: "Progress as Created by Historical Thinking." The following two short passages taken from this section answer the foregoing question in the affirmative:

> In such senses and in such cases as these [enumerated by the author], progress is possible. Whether it has actually occurred, and where and when and in what ways, are questions for historical thought to answer. But there is one other thing for historical thought to do: namely to create this progress itself. For progress is not a mere fact to be discovered by historical thinking: it is only through historical thinking that it comes about at all. [Emphasis added]

> The reason for this is that progress, in those cases (common or rare) when it happens, happens only in one way: by the retention in the mind, at one phase, of what was achieved in the preceding phase. The two phases are related not merely by way of succession, but by way of continuity, and continuity of a peculiar kind. If Einstein makes an

> advance on Newton, he does it by knowing Newton's thought and retaining it within his own, in the sense that he knows what Newton's problems were, and how he solved them, and, disentangling the truth in those solutions from whatever errors prevented Newton from going further, embodying these solutions as thus disentangled in his own theory (64 , p. 333).

Historical Perspective

What is most remarkable about the activity of accounting is the assertion by some historians that the invention of writing did not merely provide a crucial accounting tool, but that accounting contributed to the invention and development of the art of writing, indicating that accounting constitutes one of the basic needs of human beings in society. This interesting opinion is offered by at least two authors. Professor Williard E. Stone quotes the famous historian Gordon V. Childe's The Most Ancient East (K. Paul, Trench, Trubner and Co., Ltd., London, 1929), as follows:

> It is highly significant that writing had been invented not to record the warlike deeds of kings nor yet to express theological dogmas, but for strictly practical purposes connected with the administration of the temple's estates; apart from school texts, the earliest tables contain exclusively accounts (65 , p. 284).

This view is confirmed by Eric Hoffer in his book, The Temper of our Times (Harper & Row, 1966), as cited in an AICPA Publication entitled Designers of Order:

> We are often told that the invention of writing in the Middle East about 3000 B.C. marked an epoch in man's career because it revolutionized the transmission of knowledge and ideas. Actually, for many centuries after its invention writing was used solely to keep track of the intake and outgo of treasuries and warehouses. Writing was invented not to write books but to keep books (66 , p. 1).

The above two quotations also throw light on the earliest function of accounting, viz., to keep a record of assets and the flow of assets which is a management function (cf. "the administration of the temple's estates" and "to keep track of the intake and outgo of treasuries and warehouses.") Up to the advent of capitalism, wealth was concentrated in the hands of the church, the state, powerful rulers, and a relatively few wealthy citizens who were allowed by the political powers to accumulate large estates in the form of land, livestock, commodities, and slaves. To control these large concentrations of wealth the possessors had to resort to some form of accounting. Kenneth Most, for instance, suggests that "accounting was not the product of 'the period of early capitalism' but was, in fact, introduced into the public sector much earlier in time, for planning and control purposes" (67 , p. 73). It should be fairly obvious that the art of early accounting had not been invented through basic research, for the purpose of being made available to stewards of wealth as a tool for planning and control. Accounting methods had to be developed to fulfill the needs created by the accumulation and concentration of wealth. What were these needs? In Most's opinion, the primary needs called for aids to planning and control and a secondary need required a measure of accountability, or accounting for stewardship.

The production of wealth in those early times involved actions very different from the modern economic processes. Wealth arose from taxes levied by rulers, spoils of wars and raids, contributions and donations by members of a church, and production by slaves. Planning would thus be concerned with these methods of obtaining objects of value; the notion of profitability in the sense of an excess of economic

accomplishment over effort, i.e., benefit over cost, was absent. Accounting for stewardship over assets is actually part of the control function. Thus, accounting needs were limited to the management of wealth already created which in turn limited the development of accounting accordingly.

Eventually, however, new needs developed. During the Middle Ages trade began to flourish in Italy and a new class came into being, the entrepreneur. He would risk his capital in ventures undertaken by himself and assisted by employees who received wages. Ventures abroad required more capital and joint ventures were undertaken. This required a division of the profits between the venturers. Although this could be accommodated by selling all the wares and dividing the money received in some agreed ratio, one can easily conceive of many problems in connection with unsold goods, goods taken by venturers for personal use, different quantities of services rendered by individual venturers; for instance, one stays at home while the others go abroad. A new need was clearly created and a reasonable assumption is that attempts would have been made to accommodate these demands.

Permanent partnerships followed closely on the heels of temporary joint ventures. The new organizational pattern revealed partner-owners, who contributed capital, and claimed all the profits of the undertaking after payment of wages, interest, and other expenses. The idea of a calculable profit or loss was well conceived in the 15th century, as is illustrated by the 27th chapter of Paciolo's treatise, "Particularis de Computis et Scripturis," in Summa de Arithmetica, Geometria, Proportioni et Proportionalita, under the heading: "The Well Known Account Called Profit and Loss, or Profit and Deficit" (68 , p. 83).

Although he included a chapter on "The Well Known Account Called Partnership," he failed to indicate how each partner's share of the profit should be calculated, which would have been interesting since it was the practice at that time to debit the profit and loss account with personal expenses of the owner.

The value to the businessman of systematic accounting can be regarded as the basic theme of Paciolò's classic treatise. As business entities increased in size, they experienced the need for a planning and control tool similar to those used by earlier governmental, ecclesiastical, and other institutions. That accounting was an indispensable tool to the businessman during the 16th, 17th and 18th centuries is emphasized by Onko ten Have in his doctoral dissertation, De Leer van het Boekhouden in de Nederlanden tijdens de Zeventiende en Achttiende Eeuw. He writes:

> Accounting Indispensable
>
> Knowledge of accounting was regarded as very important to the trader. J. P. Coen, for instance, had been highly honored for his knowledge of double-entry accounting. Such knowledge was indispensable to the commerce and trade of Holland. Since this trade was the center of interest, it is no wonder that accounting enjoyed special attention.
>
> Accounting a Complete System
>
> De Waal (De Leer van het Boekhouden in de Nederlanden tydens de 16de Eeuw) presented a complete description of the status of accounting at the end of the 16th century. "Form and substance" of accounting was completely accomplished. It was the "compleat" system for commerce and trade in all its branches (69, p. 21). [Translated from the original Dutch]

The evolution of accounting and auditing in response to ever-changing needs is aptly expounded by A. C. Littleton in Accounting Evolution to 1900. His detailed study led him to believe that

> Accounting originated in known circumstances in response to known needs; it has evolved and grown in harmony with its surroundings; its changes can be explained in terms of forces current at the time (70 , p. 362).

He indicates that the development of accounting coincided with the extensive commerce which followed the crusades and seemed to "require a proprietary commerce rather than an aristocrat-slave commerce" (70 , p. 362). During the first centuries of its development, the proprietorship and partnership were the organizational forms of business. There was "no pressure which could produce anything more than certain refinements in technique in the interest of increased accuracy and economy of recording effort" (70 , p. 362).

The 19th century, however, provided the "pressures" and "antecedent conditions." The pressure of expanding commerce led to incorporation of business by statute. Due to England's prior unpleasant experience with stock speculations in the eighteenth century, the statutes prescribed audits. Audits had been the recognized methods of control in the preceding feudal times and only needed adaptation in order to serve the new needs. The experts who could carry out complicated audits were available from the ranks of those "who had delved into the inner intricacies of accounts in bankruptcies and other litigation and therefore had a deeper knowledge of ways and means than could have been obtained merely from writing up transactions" (70 , p. 364). The bankruptcy work arose from the statutes enacted to protect business creditors during the long series of financial crises which England experienced so that "it is evident that business crises of the 19th century were contributing factors to the development of professional auditing" (70 , p. 364). Littleton depicts the factors contributing to the development of 19th century accounting and auditing in the following figure:

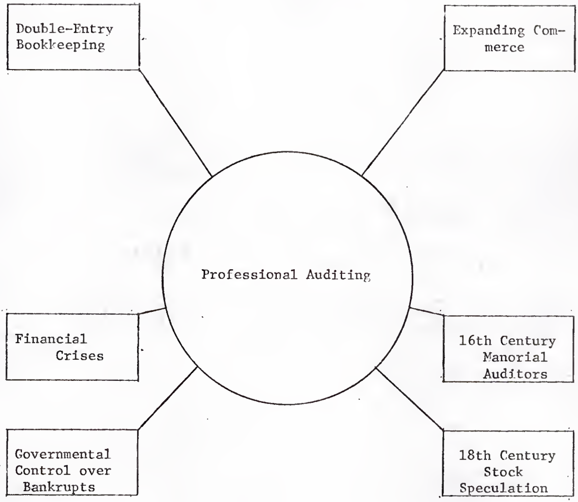

Figure 5-1. The Antecedents of Professional Auditing

Source: A. C. Littleton, Accounting Evolution to 1900 (American Institute Publishing Co., New York, 1933), p. 364.

Of special interest for the present study is Littleton's emphasis on the role of the British government in the development of accounting and auditing as a public control measure:

> Here is an excellent example of organized society (government) undertaking to limit individual action in the interest of unorganized society, the latter here represented by creditors and

> stockholders. This illustrates well the fact that the development of accounting has been relative to society's development. It is unlikely that professional auditing would have appeared when and where it did if England had lacked a parliament or had had one which was unresponsive to the social needs of the time (70 , p. 365).

It is thus clear that, apart from the utilization of accounting by governments in the management of their own affairs, accounting already fulfilled a dual function at the end of the 19th century. Internal accounting was indispensable for management purposes and public accountancy (auditing) was an established institution for the protection of stockholders and creditors. The auditor had become, in the famous remark by Lord Justice Lopes, "a watch-dog on behalf of the shareholders" (71 , p. 88).

If Littleton's plausible thesis* that "the development of accounting has been relative to society's own development," be accepted, an examination of developments in both society and accounting from 1900 to the present time should be interesting.

Environmental Developments: 1900 - 1970

Discriminate selection is required for the discussion of this topic. The United States is selected as the society of interest and the

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* Compare Littleton's thesis with the following assertion by Professor Harvey T. Deinzer: "The historical premise is that events are interactions; the latter have both antecedents and consequences. The more influential of the events are brought forward against a backdrop of the conditioning environment. Further perspective may be developed by advancing certain of the characteristic events, say the 'accounting events,' toward the lens position, while leaving the other factors in the background as a conditioning flux"(72, p.10).

relevant aspects to be examined are: constitutional changes; institutional changes, with specific reference to the industrial system; and social changes.

Ten amendments, 16 through 25, to the Constitution have been ratified in the last seventy years. Most of them deal with changes in election procedures and the status of the president. Amendment 19 extends voting rights to women and amendment 16 grants Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." [Ratified February 3, 1913] The 16th amendment can be regarded as one of the pressures, in Littleton's terminology, which exercised a strong influence on accounting. New needs were created, a need to distinguish carefully between income and capital, which is a problem for accounting theory and a need to control information rendered for tax purposes which is a problem for government and the public accounting profession.

The first chapter in Galbraith's book, The New Industrial State, is entitled "Change and the Industrial System." The pertinent changes in this country's industrial institutions, as seen by this illustrious writer and economist, are as follows:

> As to change there is no doubt. The innovations and alterations in economic life in the last seventy years, and more especially since the beginning of World War II, have, by any calculation, been great. The most visible has been the application of increasingly intricate and sophisticated technology to the production of things (73 , p. 1).

The sphere of influence and "personality" of the corporation have changed. Seventy years ago incorporation was still confined to those industries where large-scale production demanded it. Now it has invaded the province of the individual proprietor in all branches; even

professional bodies can incorporate. The 500 largest corporations are responsible for close to half of the annual production of goods and services in the United States. He continues:

> Seventy years ago the corporation was the instrument of its owners and a projection of their personalities . . . . The men who now run the large corporation own no appreciable share of the enterprise. They are selected not by the stockholders but, in the common case, by a Board of Directors which narcissistically they selected themselves (73 , p. 2).

Also the relation of the state to the economy has changed. Not only do the services of Federal, state, and local governments now account for almost 25 percent of all economic activity, but government also undertakes to regulate total economic growth, employment levels, prices, and other economic variables. In this policy of stabilization the government has been fairly successful, as no serious depression has occurred since World War II and in only one year did real income fail to rise. Inflation and unemployment have exceeded established bounds since 1969, but the point of interest is that the government is currently applying strong measures to force this irregularity back to normal.

In addition to changes in the "Technostructure," a term coined by Galbraith, the role of the corporation, "Big Business," and the increasing influence of government, "Big Government," three further changes have occurred which "are less intimately a part of the established litany of accomplishment" (73 , p. 3). These are the massive growth of advertising which in its cost and in the talent it commands, is coming increasingly to rival the effort devoted to the production of goods, the "beginning of the decline of the trade union," (73 , p. 3) and finally the "large expansion in enrollment for higher education together with a somewhat more modest increase in the means for providing it" (73 , p. 4).

Galbraith views all these changes as part of a yet larger matrix of change by which he presumably means the change from a small firm market economy to the "New Industrial State" characterized by the large "countervailing powers," as expounded by him in American Capitalism: The Concept of Countervailing Power (74) and "affluence," the theme of The Affluent Society (75). His observation of today's economic environment leads him to the following conclusion:

> . . . we have an economic system which, whatever its formal ideological billing, is in substantial part a planned economy. The initiative in deciding what is to be produced comes not from the sovereign consumer who, through the market, issues the instructions that bend the productive mechanism to his ultimate will. Rather it comes from the great producing organization which reaches forward to control the markets that it is presumed to serve and, beyond, to bend the customer to its needs (75 , p. 6).

This is an extreme viewpoint and, although it has a number of proponents, the majority of economists in this country would not unconditionally subscribe to it. This point was debated in England, a country somewhat more socialistically oriented than the United States, by Galbraith and Professor William F. Buckley, Jr. in 1970 and the British students who participated in the debate rejected the motion "The house holds the market is a snare and a delusion" by a vote of 200 to 118. The point of importance, however, is that at least some changes are believed to have taken place in the economic environment over the last 70 years, changes that may perhaps signify renewed pressures on accounting to sharpen its measurement and communication tools. To this end, the following remark by Galbraith offers food for thought:

> Similarly the theory of the firm, and how it maximizes its revenue in the market, has undergone endless refinement in recent decades. This theory assumes that the man who maximizes the revenue gets that revenue or a compelling share. So he does on a Wisconsin dairy farm. But this is not so in the modern

> large corporation where the management is on a salary and the beneficiaries are stockholders whom the managers have never seen. Although the large corporation, like the union, is far from new, it has never been really assimilated into the main body of economics (73 , pp. 410-411).

This raises the question whether the large corporation has been assimilated into the main body of accounting theory and practice, or whether accountants and auditors still view their role in the light of the corporate relationships of 1900. If the traditional economic theory of the firm has lost some of its relevance, what theory can replace it? Before these questions can be considered, a brief glance at some social changes is appropriate.

In The Affluent Society Galbraith describes the rise of a New Class.

> The New Class is not exclusive. While virtually no one leaves it, thousands join it every year. Overwhelmingly the qualification is education . . . .There can be little question that in the last hundred years, and even in the last few decades, the New Class has increased enormously in size. . . . In the United States of the eighteen-fifties it could not have numbered more than a few thousand individuals. Now the number . . . is undoubtedly in the millions (75 , p. 266).

The emergence of this new class is the result of the increased standards of living made possible by industrialism. More efficient ways of production enhance the productivity of man manifold. Manual work is taken over by machines, leaving the intellectual work to human beings. Personal incomes have risen steadily for decades. More people can thus afford higher education and vocational training. These assertions are substantiated in tables 5-1 and 5-2 and figures 5-2 and 5-3, below:

Table 5-1

MONEY INCOME - PERCENT DISTRIBUTION OF FAMILIES BY INCOME LEVEL AND RACE, IN CONSTANT (1968) DOLLARS: 1950-1968

	White		Negros and Other Races	
	1950	1968	1950	1968
Up to $3,000	23.4	8.9	55.4	22.8
$ 3,000 - $ 4,999	26.8	11.0	29.7	21.9
5,000 - 6,999	22.9	14.3	9.2	16.5
7,000 - 9,999	16.6	24.0	3.7	17.7
10,000 - 14,999	10.2	26.1	2.1	14.7
15,000 and more		15.7		6.3
Median Income	$4,985	$8,936	$2,704	$5,590

Source: U. S. Department of Commerce, Bureau of the Census, Statistical Abstracts of the United States, 1970.

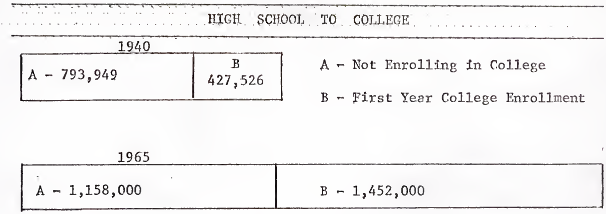
Table 5-2

COLLEGE ENROLLMENT: 1940 - 1978

Year:	1940	1950	1960	1970	1978
Millions:	1.4	2.7	3.3	7.3*	9.7*

Source: These United States (Readers Digest Association, Inc., New York, 1968), p. 104.

* Projection by the Office of Education, U. S. Department of Health, Education and Welfare.



This bar chart shows how the desire for a college education has increased among high school graduate. In 1940, 35 percent of the graduates went on to college; in 1965, 55 percent. When one considers that the high school graduating classes in the early 1940's were less than half those in the 1960's, three times as many high school students are going on to college. Almost five times as many students are entering graduate school now.

Figure 5-2. High School to College

Source: These United States (Reader's Digest Association, Inc., New York, 1968), p. 104.

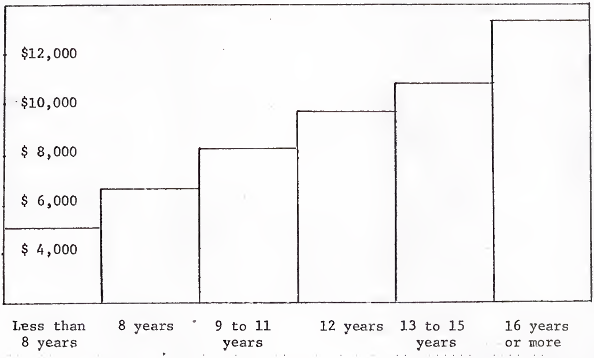


Figure 5-3. Median Family Income by Year of School Completed by Head of Family (1968)

Source: U.S. Department of Commerce, Bureau of the Census, Statistical Abstracts of the United States, 1969.

There is reason to believe that this process will continue. The significance of these developments is that the ordinary worker is becoming a member of the middle class, aspiring to join the "new class" or to see his son join it. For the worker of today his job is not just a source of immediate income. He expects much more. He is interested also in future income and security for himself and his family, not only until retirement but also thereafter. He further prefers employment that offers satisfaction, escape from boredom and routine, and a feeling of accomplishment. For these reasons his interest in his employer, the organization of which he is a part, goes far beyond that of his grandfather in 1900. Even if it is conceded that the ordinary workers class still outnumbers the "new class" by millions, the fact remains that the trend is in the direction of the latter class. With improved technology leading to more automation and increased emphasis on education, it is believed that a point will be reached where the new class of worker will be predominant.

Such, then, are some of the changes that have taken place in the economic environment of accounting since 1900. Many more can be added, but those enumerated should suffice to indicate the nature and trend of these changes. How did accounting respond to the new pressures? A brief account of the accounting developments during these seventy years will throw some light on this question.

Accounting Developments: 1900 - 1970

In 1952 A. C. Littleton observed that "the twentieth century is now half way through its course, and since 1900 there have been many important developments. Disregarding such political events as two world

wars, we can see many happenings in America which clearly tie in with modern accounting" (76 , p. 5). He mentions the following developments:

1. The Federal Reserve Banking System organized in 1913 induced the development of the balance sheet audit.
2. Industrial mass production and product competition after 1900 led to the development of cost accounting, organized internal control, and budgeting.
3. The assessment of income taxes since 1913 and especially the complexities and extent of war-time taxation made careful accounting more important than ever.
4. The postwar boom of the 1920's and the depression of the 1930's "revealed the fact that many methods of financing business, and not a few aspects of financial statements, were open to criticism." This led to the 1933 and 1934 securities legislation.
5. The Securities and Exchange Commission (SEC) played an important role in the development of accounting theory by "acting to extend the general acceptance of desirable standards of good financial reporting and to strengthen the independence of public accountants."
6. War-time government contracts on a cost-plus basis and price controls stimulated cost calculations.
7. Legislative recognition of certified public accountants throughout the nation and the unification of the profession into one national body strengthened the attempts towards formulation of accounting principles and auditing standards.

Professor Harvey Deinzer singles out the following developments to

illustrate the interaction between events and accounting theory and practice since 1900 (72 , Chapter 2):

1. The movement of mergers and combinations which was in full swing at the turn of the century created management needs for control data and investor needs for significant financial information, further complicated by the fact of intercorporate holdings.
2. The Income Tax Act of 1913 forced more adequate record-keeping on business.
3. The outstanding influence of World War I on accounting thought was through the concomitant of price inflation, which led to the general feeling of distrust in first-in, first-out (FIFO) inventory pricing as producing "fools' profits," and subsequently the writing-up of book values of assets to reflect higher current values.
4. The creation of super-holding companies in the 1920's resulted in the refinement of consolidated financial statements.
5. The stock market crash of 1929 and the subsequent depression discredited the practice of writing-up asset values and prepared a favorable political climate for creating investor safeguards in the form of securities regulation.
6. A consequence of the policy of the SEC to stimulate the accounting profession to regulate itself was "the beginning of organized search into the more fundamental bases of accounting methodology."
7. Permission by the U.S. Treasury to use the last-in, first-out (LIFO) method of inventory pricing in 1938 and 1939 popularized

this method, leading to improved income-measurement but distorted balance sheet values.

Eldon S. Hendriksen provides a concise outline of accounting developments in the 20th century in Chapters 2 and 3 of his Accounting Theory. In his opinion,

> Current accounting theory is largely a result of institutional changes of the 19th and 20th centuries and accounting literature written almost entirely in the twentieth century. The main institutional changes include changes in technology, growth of railroad transportation, the development of the corporation, regulation of quasi-public corporations, and the taxation of corporate and personal incomes (77, p. 48).

The question, "how did accounting respond to the new pressures?" has been posed earlier. In order to explore this question, two opposing approaches in accounting theory development should be distinguished. According to the first approach, the function of accounting theory is to explain and rationalize accounting practice. Early accounting, perhaps better described as bookkeeping, was primarily a technique which had been developed by businessmen for the purpose of providing them with the information needed to administer the operations of the firm. The growing size of business firms and the concomitant need for capital added a secondary function, that of providing information to investors and creditors. While both groups are interested in the safety of their money, investors are also interested in the return on their capital. Practical accountants gradually developed a set of rules and procedures for calculating the net income of a given entity for a specific period and its financial position at a certain point in time. These were the rules and procedures to be explained and rationalized by theory. This approach had some advantages, e.g., theorists had to watch practitioners and businessmen closely. Thus, the resulting theory was descriptive

with reference to what accountants were doing. However, events that occurred during the first three decades of the twentieth century demonstrated that accounting procedures had not always been sound and could not be relied on as a foundation for accounting theory.

Some observers maintain that company reporting had been a contributory factor towards unjustified security price inflation during the years immediately preceding the stockmarket crash of 1929. Support for this viewpoint is privided by the fact that the period of depression and recovery following the crash was characterized by the most strenuous efforts ever to formulate a body of sound accounting theory and auditing standards and to regulate financial reporting. The first statement on accounting principles by the AAA was issued in 1936 and the accounting procedures committee of the American Institute of Accountants issued the first accounting research bulletin in 1939. An Introduction to Corporate Accounting Standards (14) by Paton and Littleton appeared in 1940. However, apart from a few efforts towards a change in approach by individual theorists, the general approach remained that of explaining and rationalizing practice.

A new attitude towards theory formulation began to develop, especially after 1950, and in 1959 the Accounting Principles Board (APB) succeeded the Accounting Procedures Committee of the AICPA. The APB initiated the new program aimed at establishing a basic accounting theory framework to guide the solution of subsequent accounting problems. Theory had to become the foundation of practice, not vice versa. This change in attitude may be attributed to an increasing awareness on the part of accountants of the impact of their actions on the environment and to the desire to elevate the scientific status of accounting. This

desire explains the attempts to construct a basic theory through the application of a systematic method. One particular method that received a great deal of attention from both the accounting profession and accounting scholars is the postulational approach.

The Postulational Approach

"In a scientific sense, the accounting discipline is young and is desperately in need of a formal structure" (19, p. 8). In these words Professor S. C. Yu expresses an accounting need which must also have been the motivating force behind W. A. Paton's path-breaking study, Accounting Theory, published first in 1922, in which the term "postulate" was introduced to accounting theory (13, pp. 471-499). Since that date a number of accounting scholars have essayed to identify the basic postulates of accounting. In a brief survey of the historical development of accounting postulates, Professor K. Arai lists 13 authors and committees, in addition to Paton, who suggested postulates, "underlying concepts," "basic conventions," "basic concepts," and "basic assumptions" to serve as a foundation for accounting principles (78, pp. 1-4). To this list can be added a number of other names, such as DR Scott and Richard Mattesich. Recognizing this trend, the Special Committee on Research Program of the AICPA proposed in 1958 that "an immediate project of the accounting research staff should be a study of basic postulates underlying accounting principles generally, and the preparation of a brief statement thereof" (79, preface). The special committee contended that:

> Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear their understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development

> of rules or other guides for the application of principles in specific situations (79 , p. 1).

Not all theorists agree that the postulates of accounting are few in number. Professor Raymond Chambers, for instance, lists 42 postulates and 21 derived postulates. Leonard Spacek and David Solomons, again, suggest one only - fairness and accuracy, respectively. Not only is the number of postulates in dispute, but also their character. Part of the controversy revolves around the function of accounting in society and the weight to be attached to normative considerations. The information needs of users of financial reports have been given much more attention than before. Those who are concerned about user needs contend that accounting postulates should reflect the function of accounting in satisfying those needs. Thus, "ought" as well as "is" postulates are suggested by various writers. The concern with user needs and the normative aspects of accounting are well illustrated in the standpoint taken by the ASOBAT committee of the AAA. In regard to the "possible structure of future accounting theory" the committee states:

> The preceding discussion of the nature of future accounting data and actions is based on the assumption that accounting theory of the future will be more normative and less descriptive than it has in the past. The committee concludes that the assumption is valid and that future accounting theory should place emphasis on the normative aspects of accounting measurements and communication (8 , p. 68).

It can be concluded that the developments in accounting during the 20th century include the recognition of a more extensive role for accounting in a society predicated on private enterprise. But exactly what is that role? How important is it? In order to explore these questions, it is necessary to examine briefly the structure of the private enterprise system, the functions of accounting in that system, and propositions for the extension or re-orientation of the future role of

accounting. These matters are considered in the balance of this chapter.

The Structure of the Free Enterprise System

Tables 5-3 and 5-4 illustrate the relative importance of the different organizational forms under which business is conducted in the United States.

TABLE 5-3

PERCENTAGE DISTRIBUTION OF PROPRIETORSHIPS, PARTNERSHIPS, AND CORPORATIONS, BY NUMBER AND BUSINESS RECEIPTS BY SIZE OF RECEIPTS: 1967

<table>
<tr><th></th><th colspan="2">TOTAL</th><th colspan="3">NUMBER</th><th colspan="3">RECEIPTS</th></tr>
<tr><th>Annual Receipts</th><th>Number</th><th>Receipts</th><th>Proprietorships</th><th>Partnerships</th><th>Corporations</th><th>Proprietorships</th><th>Partnerships</th><th>Corporations</th></tr>
<tr><td>Under $10,000</td><td>53.1</td><td>1.2</td><td>60.4</td><td>36.7</td><td>18.7</td><td>8.1</td><td>1.3</td><td>-</td></tr>
<tr><td>$10,000 - $25,000</td><td>17.2</td><td>2.0</td><td>18.4</td><td>16.4</td><td>10.5</td><td>12.9</td><td>3.1</td><td>0.1</td></tr>
<tr><td>25,000 - 50,000</td><td>10.7</td><td>2.7</td><td>10.2</td><td>14.2</td><td>10.9</td><td>15.6</td><td>5.9</td><td>0.4</td></tr>
<tr><td>50,000 - 100,000</td><td>8.0</td><td>4.0</td><td>6.5</td><td>13.6</td><td>13.5</td><td>19.5</td><td>11.2</td><td>1.0</td></tr>
<tr><td>100,000 - 200,000</td><td rowspan="2">8.5</td><td rowspan="2">12.7</td><td rowspan="2">4.2</td><td>10.1</td><td>13.9</td><td rowspan="2">32.3</td><td>16.4</td><td>2.2</td></tr>
<tr><td>200,000 - 500,000</td><td>6.6</td><td>15.6</td><td>22.9</td><td>5.7</td></tr>
<tr><td>500,000 or more</td><td>2.5</td><td>77.4</td><td>0.3</td><td>2.4</td><td>16.9</td><td>11.6</td><td>39.2</td><td>90.6</td></tr>
</table>

Source; U. S. Department of Commerce, Bureau of the Census, *Statistical Abstracts of the United States*, 1970.

Table 5-4

PROPRIETORSHIPS, PARTNERSHIPS, AND CORPORATIONS - NUMBER, RECEIPTS, AND PROFITS: 1967

	NUMBER (thousands)	Percent	RECEIPTS (billions)	Percent	PROFITS (billions)	Percent
Proprietorships	9,126	79	$ 211	13	$ 30	25
Partnerships	906	8	80	5	11	9
Corporations	1,534	13	1,375	82	78	66
TOTAL	11,566	100	1,666	100	119	100

Source: U. S. Department of Commerce, Bureau of the Census, *Statistical Abstracts of the United States*, 1970.

The most striking features of the structure of private business are the following:

1. Corporations account for over 80 percent of total business receipts.
2. Over 90 percent of total business receipts is produced by firms with annual individual gross revenues of more than $100,000.
3. Over 90 percent of total corporate receipts is produced by corporations with annual individual gross revenues exceeding half a million dollars.

The significance of these statistics lies in the answer to the question: Is it possible to run a firm with annual revenue of more than $100,000 or a corporation with annual revenue of more than $500,000, i.e., any firm of significant size, efficiently without the aid of accounting

controls? In a minority of cases it might be feasible, but common sense and practical experience would compell the belief that a positive relationship exists between the efficiency of their accounting systems and the overall success of at least those firms with annual revenues running into 6 figures, i.e., the 11 percent who are responsible for over 90 percent of total business receipts. If this argument appears trivial, the fact should be considered that the 500 largest corporations own well over two-thirds of all assets used in manufacturing in this country (73 , p. 75). These assets had book values of over $400 billion in 1970 and their total sales amounted to $445 billion, (80 , p. 200) about 50 percent of the Gross National Product. How would these 500 giants fare without the aid of accounting?

The Functions of Accounting

The answer to the foregoing question depends on the characteristics of the functions of accounting in a free enterprise system. This function has been identified above as a dual function. Cost and management accounting is a management tool for the direction and control of the activities and resources of the firm. Financial accounting provides information about the results achieved over a particular period for dissemination to interested parties within as well as outside the organization. The significance of the former function lies in the value of accounting as a planning and control mechanism for the utilization of economic resources. The significance of the latter function is that it would be difficult to muster the cooperation of the participants in any cooperative effort such as joint ventures, partnerships, cooperative societies, and corporations, if they were not provided with information

which might enable them to assess the probable results of their association with the organization.

Accounting is often criticized for not performing its functions satisfactorily enough. An analysis of such criticisms reveals that they are usually directed towards the achievements of accounting in the area of external reporting rather than the area of cost and management accounting. In spite of legislation and attempts at governmental regulation, the problem of external reporting has not yet been resolved satisfactorily, mainly due, perhaps, to the unsettledness of conceptual issues in accounting. These criticisms raise the question of how the quality of external financial reporting may affect the functioning of the free enterprise system.

It is argued in Chapter 4 that the quality of accounting information provided to actors in markets may affect the efficiency of the achievements of the market mechanism. This concerns both "internal" information used in the decision-making processes of entrepreneurs and "external" information used in the decision-making processes of external users (actors in the markets). Thus, insofar as a free enterprise system is dependent on the market for a supply of factors of production and a market for its output, the quality of external reporting does concern free enterprise. This conclusion is based on market technicalities. However, there is also another dimension to be examined. The participants in free enterprise are human beings. This poses behavioral considerations. Why do people participate in corporate organization, the most important form of business organization, as indicated above, and what do they expect in return? The following extensive

answer to this question is given by Edwin H. Caplan in a 1966 article, entitled: "Behavioral Assumptions of Management Accounting":

> Organizations are viewed as cooperative efforts or coalitions entered into by individuals in order to achieve personal objectives which cannot be realized without such co-operation. These individuals are motivated to join the organization and contribute to the accomplishment of its objectives because they believe that in this way they can satisfy their personal goals. It is important to note that these personal goals include social and psychological, as well as economic, considerations. Thus, the survival and success of the organization depend on the maintenance of a favorable balance between the contributions required of each participant and the opportunities to satisfy personal goals which must be offered as inducements to secure effective participation (81, p. 502).

As suggested by the title of the article, Caplan is interested in the influence of managerial accounting on personal behavior within the organization. When utilizing accounting as a management tool, the goals of the participants have to be considered seriously. Caplan compares the "traditional management accounting model of the firm" with the "modern organization theory model." While the former model "emphasizes such concepts as profit maximization, economic incentives, and the inherent laziness and inefficiency of organization participants" (81, p. 508), the latter model "assumes that management must <u>influence</u> the behavior of others" through recognition of and acting on the "broad spectrum of needs and drives of the participants" (81, p. 506). These needs and personal objectives or goals of individuals motivate them to participate in an organization and only through allowing them to satisfy their wants is management able to influence them to cooperate to the extent required for successful operation of the collective effort. Not only must their needs be satisfied, but they should also be provided the kind of information that will help them to judge the efficacy of the organization in helping them to reach their goals.

Caplan's model is equally relevant to the area of external reporting. External reporting serves the needs of two distinguishable groups, i.e., participants and non-participants. The former group consists of only three parties, viz., management, investors and employees. The non-participant group is extremely heterogeneous, consisting of customers, suppliers, government, the general public, local authorities, educational and charitable institutions, economists, in short, practically every member of society. Caplan's model is relevant to the needs of the former group, the active participants - present and prospective. He points out that the personal goals of participants include, in addition to economic goals, social and psychological goals. While accounting is admittedly not the obvious vehicle for reporting to participants in regard to the accomplishment of their social and psychological objectives, it is eminently appropriate as a means of informing them about the degree of accomplishment of their economic objectives - past, present, and probabilities regarding the future.

Accounting has been accused of failure in the proper performance of its function to inform corporate participants about the degree of accomplishment of their economic objectives. And yet, participation is elicited more than ever before. The total number of stockholders runs around the 30 million mark. Industry does not suffer a shortage of capital. Professional managers are available in abundance. Nor is there a shortage of workers. These arguments, however, prove neither that the accounting information function is performed satisfactorily, nor that corporate participants are satisfied. The free enterprise system is plagued by a perennial conflict between management and labor and sometimes also between management and investors. Traditional

accounting reports do not always indicate clearly the total shares of value added allotted to each of the three participants. Nor are the sizes of the relative shares stated in comparable terms. In many cases the share of common stockholders is overstated; for example, by ignoring price level changes, as illustrated by Ralph Jones in his empirical study of the effect of inflation on capital and profits.* This may, quite understandably, lead to claims by labor for an increased share, which would not have been the case, had profits been calculated with due consideration of price level changes.

Viewed from a particular angle, labor enjoys some of the benefits of a partner (sharing in the value added through operations) but without assuming the disadvantage of sharing in the losses. This situation is not apparent from financial reports. In this connection an interesting statement by P. D. Leake (addressing the Leeds District Accountants Student Society in 1931) is relevant. He said:

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* Ralph C. Jones, "The Effect of Inflation on Capital and Profits: The Record of Nine Steel Companies," Journal of Accountancy (January, 1949), p. 13: Jones found the following discrepancies between financial data as reported by the companies and the same data, adjusted for price level changes:

Reported Data	Adjusted Data
Dividends earned by a substantial margin every year	Dividends not earned in any year since 1941.
Income retained to provide additional capital, \$543 million	Dividends, interest, and income taxes paid out of capital, \$409 million
Working capital increased 51 percent during seven-year period	Working capital increased 2 percent during seven-year period.
Fixed assets decreased 6 percent during seven-year period	Fixed assets decreased 19 percent during seven-year period.

> Those entitled to what we call profits . . . either take the profit or bear the loss. And the losses are generally due to the fact that professed partners have been paid in the form of wages and salaries more in amount than has been produced. When these things are better known, wage earners will become helpful and sympathetic, rather than antagonistic to their employers (82 , p. 348).

Mr. Leake may have overstated his case, but it is quite conceivable that a different system of reporting under which the facts mentioned by him are pointed out may have an alleviating effect on labor relations.

Some groups of investors complain that they are treated inequitably by management due to unfair and unjustified application of a wide range of acceptable accounting principles. As a result, better informed investors, often so-called insiders, gain at the expense of those investors who rely unwittingly on published financial statements. Apart from the ethical aspects of this situation, it may eventually affect adversely the flow of capital into private enterprise.

Employees may also have valid grounds for discontent. It has been shown earlier that the educational and living standards of workers are steadily increasing. As workers move up into the higher classes they develop new needs, desires, and interests. Among other things, they view their employing organizations in a new light. They have a more permanent interest in the companies that employ them, are more interested in the financial strength and future growth of these companies, and prefer to be treated as members of the organization rather than purely vendors of service. This new pressure on management and accounting is not ignored but it does not receive a sufficient response. Although many companies already recognize that their employees also desire information, relevant to their personal objectives, much more need be done to improve the information system that links management and

employees.

The foregoing discussion is not intended to be exhaustive of the function of accounting in the direction of free enterprise as manifested in corporate organization. It should suffice, however, to illustrate the general problem, viz., that what is really a community of interest among participants in a cooperative effort to satisfy their personal goals through joint action often assumes the form of a conflict of interests. Accounting performs an important communication function but discontent exists concerning the present achievement in this area. This discontent leads to conflict among corporate participants, a situation which may eventually prove to have adverse effects on the free enterprise system.

Extension of the Boundaries of Accounting

In view of the general recognition that accounting performs a function in contemporary society much broader than that of being merely an "indispensable management tool," a new generation of accounting theorists has essayed to expand the accounting theory framework accordingly. In this regard, two concepts, among others, have received special attention in recent years, namely,

1. the "behavioral aspects" of accounting actions and
2. the "social potentiality" of the accounting discipline.

"Behavioral accounting" theorists emphasize the objectives and goals of participants in the organizations for which accounting is performed. In a 1961 article, "The Emerging Theoretical Structure of Accountancy," Norton M. Bedford and Nicholas Dopuch contend: "With respect to the scope of the accounting function it should be realized that the need to

expand the accounting function beyond the traditional aspects of transactions is most pressing" (83, p. 71). These authors reject the traditional theory of the firm to the extent that it postulates profit maximization as the primary or single goal of the business entity and substitute the thesis that corporations have multiple goals. They suggest that accountants should recognize this and devise means for reporting on these goals as well as on profit performance. Separating the interests of owners, society, and active participants, they state:

> . . . an enterprise may be considered to achieve its highest potential when it has fulfilled:
>
> its functions as a technological unit in the sense of achieving a degree of technical efficiency as represented by a certain level of sales, financial position, growth, and income;
>
> its functions as a sociological unit operating within a form of super-ordinate system of values wherein the achievements by the firm of the more socially-oriented goals would be evaluated;
>
> its function as a unit of satisfying human relations needs of its participants . . . (83, p. 74).

Two years later, in 1963, Thomas R. Prince published his study, Extension of the Boundaries of Accounting Theory (84), in which he substitutes the "long-term motivational goal" and "intermediate measures" for the multiple goals of the firm suggested by Bedford and Dopuch. Prince emphasizes the importance of the recognition by management of "the different drives of individuals, the concept of role theory, and the area of role conflict" (85, p. 53). With special reference to employees, as organizational participants, he states:

> . . . direct and indirect financial payments and nonfinancial factors are all encompassed in the realm of motivation of the individual worker to make his best contribution to the enterprise's long-term goal (85, p. 52). [Emphasis added]

Here the success of an enterprise is admitted to depend, among other things, on the cooperation of employees and that it is appropriate for

accounting to recognize this fact and include it in the accounting theory framework. Consequently, Prince includes in his "Basic Postulates of the Modified Structure" of accounting theory "worker performance and attitude" as one of the "postulates of motivation" (85, pp. 56-57).

Another outstanding contribution was made by Edwin H. Caplan when his article "Behavioral Assumptions of Managerial Accounting" was published in 1966. Many studies in this area were undertaken in the 1960's. In 1969, William J. Bruns and Don T. DeCoster published forty studies in the area of behavioral accounting in a readings book, Accounting and Its Behavioral Implications (86). The majority of these readings focus on two participants: management and employees, with only a few alluding to the third one, investors. However, a number of studies on investor behavior were undertaken during the same period and are reported elsewhere (55, 56, 57, 58).

The object of reporting all this activity in the field of accounting is to afford insight into the function performed by accounting in a free private enterprise economy; to illustrate the widely held view of accountants that accounting has a function to fulfill in the successful operation of business organizations; and to emphasize the importance of the human element, the need for cooperation among organizational participants, and the role that accounting information plays in the achievement of cooperation and the realization of goals.

The second candidate for inclusion in the accounting theory framework is the concept of "socio-economic accounting" (87, p. 37). An increasing awareness of the social implications of accounting measurements and communications has motivated accountants in recent years

to pay more attention to this phenomenon. This proposed extension of the boundaries of accounting involves the recognition of a much broader function of accounting, namely, that of serving as a "tool of society," in addition to its established functions as a management tool and a communication device. Although this new development may pose important public interest consequences, it is still too unsettled to include in the present study. It is mentioned, however, to indicate that accounting scholars are aware of the potential of accounting to serve public functions as well as private functions.

Conclusions

The historical evolution of accounting presented very briefly in this chapter illustrates the capacity of accounting to respond to the needs of the users of accounting information, and to varying environmental conditions. It also illustrates the expanding role of accounting from a "planning and control tool" in the hands of ancient governmental, ecclesiastical, and other public institutions to a "business tool"; to a "management tool"; to a "governmental tool" for the control of the interests of absentee owners and creditors, i.e., auditing; to an "organizational tool," as an organizational information system, successively, and in the future perhaps to a "social tool."

Of special interest to the purpose of this chapter is the role of accounting as a management tool and as an organizational information system. First, the production of goods and services in the United States is undertaken by private enterprises and the bulk of production is in the hands of medium and large organizations, mainly corporations.

The performance of these enterprises and accordingly the performance of the total economic production of the country depends in part on the accomplishment of accounting as a tool of management. Second, organizational participants (management, investors, and employees) are motivated by personal objectives to participate, and need an information system

1. to determine the objectives of fellow participants and the goals of the organization as determined by the management, and
2. to determine the extent to which their objectives have been satisfied by the organization.

The personal objectives of the participants include social, psychological, and economic considerations. Accounting is an effective vehicle for measuring and reporting the economic accomplishments as they affect the individual participants or groups of participants. The effectiveness with which accounting performs this function contributes to the efficiency of the free enterprise system.

Although the famous "Sombart Propositions" to the effect that "the invention of accounting was vital to the development of the capitalistic enterprise" (67, p. 51) has been criticized by some writers, including B. S. Yamey (88, pp. 13-30) and Kenneth S. Most, these critics as well as other scholars find some degree of validity in the assertion that capitalistic business enterprise is significantly aided by accounting in the achievement of its goals. If Sombart's propositions had some validity at the turn of the 19th century, when his ideas were formulated, they carry even more weight today by virtue of the fact that accounting assumes the additional function of serving as an information system to the currently much larger numbers of organizational participants whose cooperation is vital to the efficient performance of private enterprise.

CHAPTER 6

THE RELEVANCE OF THE PUBLIC INTEREST TO ACCOUNTING THEORY AND PRACTICE

The purpose of this chapter is, first, to synthesize the inferences drawn from the materials presented in Chapters 1 through 5 with a view to passing judgment on the validity of the thesis that the concept of public interest is relevant to accounting and, second, to consider some implications of the outcome of the inquiry for accounting theory formulation and public accounting practice, or auditing. In order to inspect the validity of the thesis, it is necessary to refer back to the guiding hypothesis.

The hypothesis stipulates two conditions to be met in order to warrant the assertion contained in it, viz.,

1. that it be possible to define "public interest" operationally and
2. that it be possible to demonstrate that accounting information has the potential of affecting the public interest, so defined.

The first condition is subjected to inquiry in Chapters 2 and 3 while the subject-matter of Chapters 4 and 5 is relevant to the inquiry with regard to the second condition. A brief recapitulation may serve to indicate whether or not the conditions are met.

The first condition. - Constitutively, "public interest" can be described as a general commendatory concept used in justifying public policy or social behavior for which a nonarbitrary descriptive meaning can be

determined by relating the anticipated effects of public policy or social conduct to established community values. Operational definitions of the public interest, based on this constitutive definition, are embodied in public and private policies formulated in recognition of community values as interpreted by the governmental body or private individual or organization in question. "Government is a trusteeship, all of whose activities are properly directed to the benefit of the people or public" (23, p. 10). In the absence of evidence to the contrary, governmental policy may, therefore, be regarded as representing the official interpretation of the public interest. Private individuals and organizations are under no such trusteeship obligations; it is, therefore, less certain whether or not their policies are inspired by public interest considerations. Consequently, public policies, viewed as official interpretations of the public interest, are more capable of providing operational definitions of the public interest. As indicated by Leys and Perry, this operational view of the public interest is widely held among political scientists (23, p. 26). But, as pointed out by Professor Ernest Griffith, the public interest as manifested in governmental activity constitutes but a subheading under the broader concept (47, p. 15). It appears, therefore, that the second condition can be <u>partially</u> met by accepting public policies as operational definitions of the public interest.

<u>The second condition.</u> - Accounting is a product of its environment (20, p. 4). Not only is it shaped by its environment, but it also has an impact on social, economic, and political activities and policies that constitute its environment. Thus, the relationship between accounting and its environment is one of <u>interaction</u>. This much is generally

recognized, but the crucial question for the purpose of the present inquiry is whether or not accounting's interaction with its environment produces consequences that may have an impact on the public interest. In terms of the definition of the public interest adopted in Chapter 3, this question may be answered by relating the functions of accounting to those governmental policies where a presumption exists that accounting information may be a relevant factor in their efficient execution. Since it is a recognized function of accounting to measure and communicate economic data, the selection of public economic policy appears to be a rational starting point for such a correlation. Two of the cornerstones of capitalism are:

1. a free private enterprise system to undertake the production of economic goods and services and
2. a market mechanism to distribute the output produced and to regulate the supply of factors of production.

Thus, the governmental policies to enhance the working of the market mechanism and to promote private enterprise provide relevant operational definitions of the public interest for the purpose of the present inquiry. A market equilibrium model, based on the conditions for achieving a Paretian welfare optimum in the production of goods and services so as to maximize consumer satisfaction, illustrates that accounting information, when used in market operations, may affect the efficient functioning of the market and, hence, by definition, the public interest. The functions of accounting, as an information system, in the promotion of private enterprise, are to serve as a planning and control tool in the hands of business management and to enhance harmonious cooperation among organizational participants. The efficiency achieved by accounting in the performance

of these functions may have an impact on the functioning of the private enterprise system and, hence, by definition, on the public interest. On the basis of the potential of accounting to affect these two important institutions of the country's chosen economic system, it appears that accounting information does have an impact on the public interest, as defined. Thus, it is demonstrated that the second condition can also be met.

Since both conditions specified in the hypothesis can be met, the thesis that the concept of public interest is relevant to accounting theory and practice may be accepted. Some implications of this inference can now be considered. In the sense that practice is guided by theory, the implications for theory and practice cannot easily be separated. Hence, the discussion of the implications for accounting theory is also relevant to accounting practice. In the section dealing with the implications for accounting practice, the discussion is limited to <u>public</u> accounting practice, or more specifically, auditing.

Some Implications for Accounting Theory Formulation

Where does the concept of public interest fit into the structure of accounting theory? Of the various approaches to theory formulation available to the theorist, the postulational method is considered here with reference to the foregoing question. According to this method postulates are selected to serve as the basic propositions of the discipline in question. These postulates serve as the foundation for the derivation of principles. Different factors may be considered in the selection of postulates, e.g., environmental conditions, functions, and goals. Although most theorists agree that environmental conditions have to be

considered in the selection of postulates, differences of opinion exist in regard to the weight to be allotted to functions and goals. It is necessary, therefore, to inspect the characteristics of goals and functions more closely in order to determine their relevance in the selection of a set of postulates.

"Goal" is defined in Webster's New Twentieth Century Dictionary of the English Language (1964 reprint) as: "The end or final purpose; the end . . . to which a person aims to reach or accomplish." Thus a goal is purposive. Goals are chosen. Consequently, promotion of the public interest may become a goal of accounting practice if so chosen by the profession. The profession may be motivated by two sets of conditions to adopt such a goal, viz., ethical and pragmatic considerations. Examples of the former are: patriotism (interpreted as the desire to further national policies), equity, fairness, and justice. A pragmatic consideration may be the possibility that improved accounting information benefits the capitalistic economic system. Should the theorist find that such a goal has been adopted by the accounting profession, he will recognize it as a relevant factor in the preparation of a set of accounting postulates.

Functions evolve through responses to needs and can be discovered by observation. The validity of considering functions in the selection of postulates is noted by Professor Chambers in the following statement: "Those [concepts] that are chosen as postulates are dictated by the function ascribed to accounting" (15, p. 395). Since functions appear to be more objectively determinable than goals, they may be preferable to the latter as a guide to the theorist confronted with the problem of selecting accounting postulates.

Finally, the place of environmental conditions in the selection of a set of postulates has to be considered. In a 1963 article, "Why Bother with Postulates?" Professor R. J. Chambers contributes towards the explication of the characteristics of postulates by illustrating the relationship between postulates and the environment of the relative discipline. In a section entitled, "What is a Postulate?" he explains:

> An attempt has been made to show by illustration what a postulate is. It will be seen on examination of all the statements described as postulates throughout this paper that none of them incorporates words or phrases which are peculiar to accounting. They are all descriptions of some thing, some event or some form of behavior found in the environment of accounting. Accounting has no justification whatever in itself. It has no rationale beyond the domain of men acting purposefully in monetary economies. All of its postulates must therefore be outside of it, must be descriptive of the world in which it plays a part. Of the thousands of statements it is possible to make about the environment in which we live, only those which deal with financial transactions or relationships or which have financial consequences or which deal with the problems of computation and communication can be related to accounting. That the same statements may at the same time be postulates or conclusions of other types of study is to be expected. In a sense it is to be welcomed, for it gives some assurance, if assurance be needed, that our concepts of the environment are not concepts we have invented for our own purposes. Those that are chosen as postulates are dictated by the function ascribed to accounting. Any proposition descriptive of the environment which is fundamentally necessary to support a conclusion, a principle or a practice in accounting is a postulate of accounting, however remote or trite it may appear to be (15, p. 395).

The Special Committee on Research Program of the AICPA contended in 1958 that postulates are few in number and that they "are necessarily derived from the economic and political environment and from the modes of thought and customs of all segments of the business community" (79, p. 1). Accepting this viewpoint, Maurice Moonitz included 5 environmental postulates in his set of 14 postulates presented in Accounting Research Study No. 1. Also the Study Group at the University of Illinois recognized the importance of environmental conditions. Introducing three

"environmental conditions influencing accounting," they state in A Statement of Basic Accounting Postulates and Principles:

> Accounting, like other human activities, is a product of its environment. This means that we must give some attention to those characteristics of the economic and social environment which have a direct influence on accounting and therefore on accounting postulates and principles (20, p. 4).

Thus, it appears that environmental conditions are generally considered to be important factors in the selection of postulates.

Against the backfrop provided by the foregoing discussion, the relevance of the concept of public interest for accounting theory can now be considered. The public interest may be recognized as a postulate of accounting for either one or both of two reasons. First, advancement of the public interest may be adopted explicitly as a goal of accounting practice. This goal, together with many other factors, will be considered by the accounting theorist in the selection of postulates for the purpose of theory formulation. Second, accounting theorists may observe that one of the organizing concepts of the social, economic, and political environment of accounting is the concept of public interest and that this concept is relevant to the practice of accounting due to the nature of the functions of accounting in a capitalistic economy. The public interest is, therefore, one of the environmental conditions that is relevant to accounting so that it has to be considered in the selection of a set of accounting postulates.

The Public Interest Reflected in Accounting Postulates

The recognition of the public interest as an environmental condition may be reflected in a set of accounting postulates by means of the addition of one environmental postulate stating the relevance of the public interest concept to accounting. Although the underlying postulate has

not been stated explicitly, many current accounting principles and practices are founded on public interest considerations. This is confirmed by the statements of accountants, accounting organizations, and accounting scholars cited in Chapter 1 and by the code of professional ethics of the public accounting profession. Professor S. C. Yu, however, states clearly that

> . . . the formulation of a meaningful theory requires a precise identification of its basic postulates, which may be unproven, but which are definitely not undefined (19, p. 6).

Implicit assumptions are, by definition, undefined. This is not satisfactory. The mere statement of the, heretofore implicit, public interest postulate has the advantage of drawing attention to the necessity of defining it. Only after agreement has been reached on specific operational definitions of the public interest is it possible to formulate accounting-domain postulates that reflect, among other things, the public interest as an environmental condition.

In the present study two operational definitions of the public interest are related to the functions of accounting, viz., preservation of the competitive market mechanism and promotion of private enterprise. In order to illustrate how these definitions can guide the formulation of accounting postulates, the following two tentative postulates are presented:

1. The Market Postulate. Accounting data and reports are information inputs to the decision-making processes taking place in the various markets and current market prices are information inputs to the decision-making processes taking place in the business entities that supply commodities and services to the product markets.

2. The Behavioral Postulate. Accounting data and reports are information inputs to the decision-making processes of organizational participants with reference to continued or contemplated participation in the activities of the entities which constitute the private enterprise system.

Similarly, accounting postulates can be stated to express the relevance of accounting information to other public policies, e.g., the policy of stable economic growth and the judicial policy of equitable treatment of all members of society in their financial dealings with each other. Perhaps postulates are not as "few in number" as is contended by some observers, but only appear to be few because so many are implicit assumptions. The presence of too many unstated assumptions has a weakening effect on a theory structure. Ideally, all significant assumptions should be stated and defined. It may be concluded that the most important advantage of the recognition of the public interest as an environmental condition of accounting is that it necessitates precise definition of the concept of public interest for the purpose of theory formulation.

The Public Interest Reflected in Accounting Principles

Accounting principles may be regarded as statements guiding accounting practice in the performance of the functions of accounting. Principles are founded on postulates and the latter are selected on the basis of such factors as environmental conditions, functions, and goals. Hence, accounting principles that are derived from a fairly comprehensive set of postulates can be expected to be consistent with the goals and functions of accounting. There need not be any one to one relationship between postulates and principles. More than one postulate may underlie a single principle and more than one principle may be rooted in a single postulate.

For illustrative purposes, however, two tentative accounting principles are now presented, each flowing from one of the two tentative postulates formulated above.

The current replacement cost principle. - The postulate, among others, underlying this principle states that accounting data and reports are information inputs to the decision-making processes taking place in the various markets and that current market prices are information inputs to the decision-making processes taking place in the business entities that supply commodities and services to the product markets. This postulate is referred to as the market postulate because it recognizes the function of accounting in directing the market mechanism. From the material presented in Chapter 4 it may be inferred that accounting can best perform this function by pricing inputs at current market prices. This can be achieved by regular adjustment of the unallocated balances of unsold and unused assets to current market replacement cost. Special circumstances may, however, prevail as a result of which such adjusted prices will be obviously unrealistic for a given entity, e.g., used equipment in a mine to be closed or technical equipment in a going concern rendered obsolete by innovations. In these cases the value of the assets may be adjusted to an appraisal value based on the circumstances of the case. In spite of the difficult practical problems inherent in any attempt to arrive at a reasonable appraisal value for individual assets of a business entity, the value arrived at may be a better indication of the value of the asset than historical cost and, thus, a better guide to actors in markets using accounting data.

The acceptance of a current replacement cost principle may produce the following benefits:

1. Accounting reports will include the same costs which rational actors in markets normally consider with regard to decisions on current and future actions.
2. Input prices of resources consumed will be fairly uniform for all entities using similar productive goods and selling similar commodities - a factor enhancing efficient resource allocation in terms of consumer satisfaction.
3. The comparability of reported income and financial position over time and among different firms may be enhanced so that stock prices, insofar as these are affected by accounting data, will better reflect the relative positions of the accounting entities. Presumably, more "realistic" stock prices, in the sense that they are based on more "realistic" financial data (income based on the matching of current cost with current revenue and unallocated resources stated in current terms) will result in more "realistic" cost of capital estimates.

In regard to the third advantage it may be noted that the numerator and the denominator in the simple cost of capital formula,

$$\text{Cost of Equity Capital} = \frac{\text{Earnings}}{\text{Market Price of Stock}},$$

are asserted to be more compatible. The probability that businessmen may be using more sophisticated cost of capital formulae does not invalidate the argument since present earnings, or expected future earnings based on present experience, and the market value of the company's stock are always elements of the formula. It is, of course, not argued that a current replacement cost principle will result in a uniform cost of capital figure for all firms. The computed cost of capital figure is

"gross" in the sense that market interest rates are gross and have to be adjusted for risk and cost factors to arrive at the rate of interest. It is only hoped that variations will be explainable to a large extent by real factors, such as differences in risk and the cost of raising capital, and not to deficient reporting.

A number of deficiencies of current replacement cost pricing have been pointed out in the past by various writers. The probability that current replacement cost may be unrealistic under special circumstances for a given firm is alluded to above. Another objection is that the valuation of individual assets at replacement cost does not necessarily result in a realistic valuation of the total entity. In regard to depreciation charges, Eldon S. Hendriksen points out that replacement cost depreciation may not reflect accurately the true economic value of the depreciation of property (77, p. 186). In spite of the deficiencies of current replacement cost for accounting purposes, writers on the subject usually enumerate also a number of advantages attaching to its use. However, a very important advantage, as revealed by the present study, does not appear to be noticed, viz., the potential of current replacement cost accounting for increasing the probability of achieving Pareto optimality in the national economy.

In view of the foregoing discussion, the current replacement cost principle may be framed as follows: The general rule is that all unallocated costs and cost expirations are stated in terms of current replacement cost. Gains and losses emerging from such adjustments are reported separately. When evidence is available that current market replacement cost is an unrealistic valuation of resources held for future use, such resources may be stated at an appraisal value or at historical cost,

adjusted for specific price changes and price level movements. The effect of such a valuation on reported income is reported separately.

The goal-accomplishment reporting principle. - The postulate underlying this principle states that accounting data and reports are information inputs to the decision-making processes of organizational participants with reference to continued or contemplated participation in the activities of the entities constituting the private enterprise system. The statement implies that the information received by organizational participants possess the quality of relevance. As pointed out in Chapter 5, organizational participants are members of the organization because they intend to use the organization to satisfy their personal objectives and group goals. They need to know whether or not their expectations are fulfilled, and if so, to what extent. Given this information, they can make their decisions with regard to future participation.

Two possible causes of discontent are, first, information to the effect that their objectives are not satisfied and, second, incorrect or incomplete information. Remedies in the first case include leaving the firm or attempting to improve the efficiency of the firm in serving the goals of the participants. The problem in the second case is that organizational participants may not be aware that reported information is deficient and that it is in their interest to consider alternative actions with regard to their association with the organization. A principle is needed, therefore, to provide the best information possible to participants with regard to the satisfaction of their objectives, but the problem is that the management of the organization does not know the objectives of individual participants. A solution to this problem is to state clearly the goals of the organization, as determined by management.

Comparison between the goals of the organization and their personal objectives then enables prospective participants to decide whether or not to enter the organization. Once individuals have entered the organization, say a corporation, the management can elicit more information from them about their objectives and group goals and provide them with information about any changes in corporate goals. Two-way communication between management and other participants with regard to goals and goal accomplishment requires a corporate participant information system. Such a communication system is depicted in Figure 6-1.

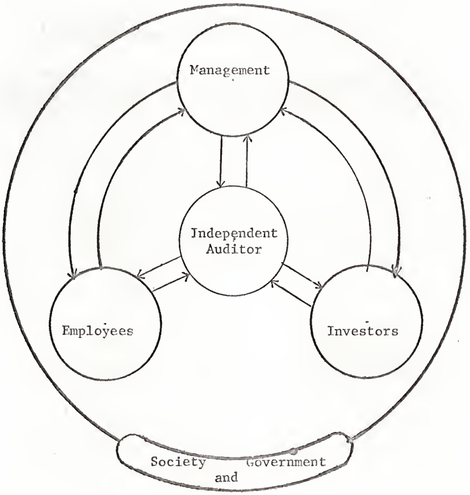

Figure 6-1. A Corporate Participant Communication Model

On the assumption that management, internal accountants, and public accountants possess accurate information about corporate goals and reasonable knowledge about group goals of participants, by virtue of the corporate participant information system, the following reporting principle can be regarded as reasonable: Accounting reports are framed in terms of goal accomplishment, i.e., they indicate as clearly as possible the cost of the effort expended in the pursuit of each goal of the corporation, separately, and the results realized in regard to each goal during the period covered by the report. In addition to general reports, special purpose reports are prepared to facilitate communication of goal accomplishment to homogeneous groups of participants.

Since the purpose of this study does not include the preparation of a set of accounting postulates and principles, the tentative postulates and principles presented above are intended for illustrative purposes only. A tentative validation of the existence of an undefined public interest postulate in the accounting environment is all that is asserted to have been achieved in this study. Since the requirements of a meaningful theory include precise identification and definition of its basic postulates, accounting theory will be strengthened by clarifying the status of, and by defining, this postulate.

Some Implications for Public Accounting Practice

Public accounting practice in the United States is regulated by the public accounting profession itself in terms of a set of generally accepted auditing standards and a code of professional ethics. The standards, ten in number, are classified under three headings, viz.,

general standards, standards of field work, and standards of reporting. Of special interest to the subject-matter of the present study are the general standards, which are:

> 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
>
> 2. In all matters relating to the assignment an <u>independence</u> in mental attitude is to be maintained by the auditor or auditors.
>
> 3. Due <u>professional care</u> is to be exercised in the performance of the examination and the preparation of the report. [Emphasis added]

The meaning to be attached to "due professional care" is clarified by the code of professional ethics, the preamble to which emphasizes the auditor's relationship and responsibilities to the public and the auditing profession in the following words:

> The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality and integrity. To this end, a member or associate of the American Institute of Certified Public Accountants shall at all times maintain <u>independence</u> of thought and action, hold the affairs of his clients in strict confidence, strive continuously to improve his professional skills, observe generally accepted auditing standards, promote sound and informative financial reporting, uphold the dignity and honor of the accounting profession, and maintain high standards of personal conduct. In further <u>recognition of the public interest</u> and his obligation to the profession, a member or associate agrees to comply with the following rules of ethical conduct, the enumeration of which should not be construed as a denial of the existence of other standards of conduct not specifically mentioned. [Emphasis added]

Interpreting the code, Carey and Doherty declare in <u>Ethical Standards of the Accounting Profession</u>:

> The code in effect is an announcement that, in return for the faith which the public reposes in them, members of the profession accept the obligation to behave in way that will be beneficial to the public (4, p. 4).

Thus, the accounting profession in the United States is seen to be patently aware of its public responsibilities and the impact of its activities on the public interest. Again, however, the question arises: Where does the concept of public interest fit into public accounting practice, or auditing? At the present time auditing has not advanced to the stage where generally accepted sets of auditing postulates and auditing principles are available. If such a body of auditing theory were in existence, a case could be made for including an environmental postulate asserting the relevance of the public interest to auditing practice in a set of auditing postulates on the same reasoning underlying its recognition in accounting theory. The explicit recognition of the public interest in the code of professional ethics would strengthen the case for adopting a corresponding postulate. However, since auditing is currently guided by "standards," it is necessary to inquire how the concept of public interest may be related to auditing standards.

Three ways in which the concept of public interest may be recognized in auditing standards are:

1. through broad interpretation of current generally accepted auditing standards (general);
2. through the reporting standard requiring that the auditor's report shall state whether financial statements are presented in accordance with generally accepted accounting principles; or
3. through the addition of a fourth general standard, requiring that the auditor shall recognize the public interest in the performance of his duties.

Each of the three alternatives is now considered briefly. In regard to the first alternative it can be noted that a duty of due professional

care is imposed on the auditor. According to Roy and MacNeill, in Horizons for a Profession, two of the common characteristics of well-established professions are that such professions render services to society and that they are governed by ethical principles which emphasize the virtues of self-subordination, honesty, probity, and devotion to the welfare of those served (89, p. 31). The professional code of ethics of the AICPA, supporting the standard of due professional care, mentions, inter alia, independence of thought and action, an attribute regarded to be so important that it is specified as a standard in its own right. Moreover, the code of professional ethics specifically refers to recognition of the public interest." A case can, therefore, be made that the general auditing standards, especially if read with the code of professional ethics, already imply the standard of public interest.

The second alternative rests on the requirement that the auditor's report shall state whether financial statements are presented in accordance with generally accepted accounting principles. At present generally accepted accounting theory does not include an explicit public interest postulate although some accounting principles can best be explained on the basis of some implicit public interest postulate. It is contended in the foregoing discourse that attention should be directed towards clarifying and defining this implicit postulate. If this can be done, future GAAP may reflect the public interest more accurately in which case the auditor's duty, based on the reporting standard underlying the second alternative, will be to consider the probable impact of the reports that he certifies on the public interest.

The third alternative, i.e., the addition of another general standard, has a similar advantage as the inclusion of an explicit public interest

environmental postulate in a set of accounting postulates, viz., drawing attention to the necessity of defining the concept of public interest for auditing purposes. In view of the absence today of a generally accepted definition of the public interest, the prescription in the code of ethics to recognize the public interest, or in Carey's words, the "pledge to the public that in consideration of public confidence the profession will protect the public interest," is vague and unsatisfactory. On the assumption that the concept of public interest be incorporated in auditing standards, some consequences of such a recognition of the public interest are now considered. Three facets of the auditor's relationships with his profession, his client, and the public are arbitrarily chosen, viz., the matter of independence generally, the auditor's relationship with his corporate client, and his duty towards society.

Independence

The requirements of the public interest as set forth above may often lead the auditor to disagree with the accounting principles or procedures applied by a business entity. The recognition of the importance of the public functions of accounting and the auditor's duty to "behave in a way that will be beneficial to the public" (4, p. 4) underline the need for independence on the part of the auditor. The high premium placed on independence by the public accounting profession is revealed by the following statement of the Council of the American Institute of Accountants, issued in 1947:

> Independence is an attitude of mind, much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature (4, p. 42).

The public interest standard adds a further dimension to the concept of independence, as currently construed, due to the increased probability that the auditor may have cause to disagree with individual business entities on the manner in which they record transactions and events and communicate accounting information. Carey and Doherty enumerate three meanings of independence, as follows:

> First, in a sense of not being subordinate, it means honesty, integrity, objectivity and responsibility. Second, in the narrower sense in which it is used in connection with auditing and expression of opinions on financial statements, independence means avoidance of any relationship which would be likely, even subconsciously, to impair the CPA's objectivity as auditor. Third, it means avoidance of relationships which to a reasonable observer would suggest a conflict of interest (4, pp. 41-42).

To these three meanings a fourth may be added, viz.: In consideration of the public interest, independence means being in such a strategic position relative to his client that the auditor's ability to observe the public interest standard is significantly enhanced. Two factors that tend to weaken the strategic position of the auditor are; first, management's power in regard to his appointment and dismissal and, second, the inadequacy of the present accounting theory framework. These two points are illustrated by the following quotations from recent literature:

First, in connection with the appointment and dismissal of auditors, a practicing CPA contends in the January, 1971, issue of The Journal of Accountancy:

> . . . the accountant's position of independence would be greatly strengthened . . . if the present relative freedom that management has in selecting auditors could be placed under reasonable restraint. Devices such as election of auditors by stockholders and audit committees of boards of directors already provide some measure of protection in many companies, and these practices should be extended. Additional measures should be considered, however, perhaps in the form of assurance to a replaced auditor that he has the right to appear at the next stockholder meeting to answer questions, or some provision for SEC or stock exchange

> investigation of changes in accounting firms. The objective should not be to preclude changes but to make unwarranted changes more difficult (90, p. 73).

Second, in connection with the auditor's position with regard to the inadequacy of generally accepted accounting principles, Arthur M. Louis reports in the December, 1970, issue of Fortune magazine:

> Some of Arthur Andersen's competitors suggest that its accounting practice is not always as pure as its preaching, and they even point to the firm's great size as evidence. . . . The competitors, who ought to know, say you can't get very far in the accounting profession if you make life difficult for the corporations you audit. They contend that Arthur Andersen, like other auditors, is sometimes willing to accommodate corporate clients who choose to interpret accounting rules liberally. A top partner of another Big Eight firm sarcastically observes: "They are engaged in as much nefarious behavior as the rest of us." The Arthur Andersen partners respond that if they certify dubious financial statements, they do so because the profession has permitted accounting rules to remain nebulous. As one of them remarks, "water seeks its lowest level" (60, p. 98).

Alleviation of these problems facing the professional public accountant may enhance his strategic position to act in ways that are beneficial to the public.

The Corporate Client

The public interest, as defined in Chapter 3, requires among other things that private enterprise be protected and promoted. Evidence is presented in Chapter 5 that the bulk of production in the United States is undertaken by corporate enterprises. According to the behavioral or organizational viewpoint, a corporation is an organization consisting of participating groups of individuals who try to achieve their personal objectives through a cooperative effort. These groups are identified above as management; investors, including creditors; and employees. In the corporate participant communication model presented above as Figure 6-1 the independent auditor is assigned a central position which

implies that he fulfills a core function. In other words, he is an independent agent of all three participating groups, especially with regard to the communication function. He has to establish two-way communication channels between himself and each of the three groups to enable him to report on the adequacy of the information in regard to goal accomplishment provided by management to investors and employees. Thus, he can contribute towards the efficiency of corporate organization, a cornerstone of private enterprise, in consonance with the public interest standard.

The Auditor and Society

Under the heading "The Accounting Profession and the New Society" in Ethical Standards of the Accounting Profession, Carey and Doherty express the following views:

> A new form of economy has arisen in this country. It might be called "supervised private enterprise." It attempts to combine the creative forces of competition in business with safeguards against exploitation of one group by another. . . . The system is made workable largely by imposing accountability on business management - accountability to stockholders, investors, creditors, government regulatory agencies, taxing authorities and others who have legitimate interests in the enterprise concerned. . . . Such a system creates many new opportunities for service by certified public accountants . . . . Certified public accountants have so far only scratched the surface of their opportunities (4, p. 45).

This view of the place of the auditor in society is in consonance with the belief that the accounting profession has public functions to perform. Figure 6-1 portrays the corporation and its auditor surrounded by its environment: society and government. No direct communication channels are indicated although at least one channel does exist, viz., between corporate management and government as a result of tax and other returns to be filed with government agencies. Members of society, other than

present participants, are also interested in the corporation for various reasons, including possible decisions regarding joining the organization. Non-participant members have to rely on reports prepared for the information of present participants. Since the two groups base their decisions on the same reports, it is important that the information be un-biased with respect to both groups. This is required by the public interest as incorporated in the judicial policy of equitable treatment of all members of society in their dealings with each other and also in the interest of continued future flows of productive resources into the corporate system. These limited observations are intended to illustrate how recognition of the public interest as being relevant to accounting theory and practice may accentuate the importance of the function of the auditor in society.

CHAPTER 7

SUMMARY AND CONCLUSIONS

The frequency with which the words "public interest" appear in the accounting literature stimulates the desire to discover more about the relevance of the concept of public interest to accounting theory and practice. In order to determine whether or not the public interest concept is relevant to accounting, an inquiry into the meaning of the concept and into the functions of accounting is necessary. Since accounting is a measurement discipline, it is necessary to find operational definitions for concepts to be related to accounting. If it can be demonstrated that the concept of public interest can be defined operationally and that accounting information may affect the public interest, so defined, then it may be concluded that the concept is relevant to accounting theory and practice.

An inquiry into the acceptability of the concept of public interest in academic and professional circles indicates that, although a number of political scientists prefer to reject the concept as an element of political theory, the majority of social scientists, politicians, economists, and lawmen find some merit in the concept as a moral guide to rulers and the ruled alike by means of which conflicts of interest may be adjudicated. The rejectionists contend that the possibility of obtaining general agreement on either a constitutive meaning or an operational definition for the concept is remote. Those in favor of

retaining the concept point out that, in spite of vagueness and operational dilemmas, the concept serves a useful purpose. Therefore, attempts should be directed towards defining it more precisely.

The political scientist, Richard E. Flathman, who made a penetrating study of the concept of public interest, concludes that

> . . . "public interest" is a general commendatory concept used in selecting and justifying public policy. It has no general, unchanging, descriptive meaning applicable to all policy decisions, but a nonarbitrary descriptive meaning can be determined for it in a particular case. The descriptive meaning is properly found through reasoned discourse with attempts to relate the anticipated effects of a policy to community values and to test the relation by formal principles (44, p. 82).

Although Flathman restricts the concept to the political sphere, it is receiving increasingly wider recognition in social discourse and philosophical thinking. His description of the nature of the concept can be broadened by expanding his statement to include social behavior in addition to public policy. However, by restricting the concept to the province of public policy, he enhances the possibility of finding operational definitions of the public interest. This possibility is further augmented by his decision to find a descriptive meaning for the concept. On the presumption that "government is a trusteeship, all of whose activities are properly directed to the benefit of the people or public" (23, p. 10), public policies formulated by governmental officials may be regarded as operational definitions of the public interest as interpreted by the said officials, in recognition of established community values. Although this is a constrained public interest concept, it is widely accepted among political scientists (23, p. 26) and has the advantage of providing a basis for the formulation

of operational definitions of the public interest.

In view of the fact that a primary function of accounting is to measure and communicate economic data, public economic policy appears to be of particular relevance to an inquiry into the probable impact of accounting information on the public interest, as operationally defined. Public economic policies include among many others, the preservation of the competitive market mechanism, the promotion of private enterprise, the pursuit of economic stabilization, and the narrowing of the wide range of income distribution. Since competitive markets and the private enterprise system are two cornerstones of a capitalistic economy and since accounting information appears to be particularly relevant to their efficient functioning, the public economic policies in relation to these two institutions provide suitable operational definitions of the public interest for purposes of the present inquiry.

According to an accepted interpretation of the general welfare, economic resources are to be used so as to maximize consumer satisfaction (given the state of income distribution and the principle of consumer sovereignty). This requires the optimal allocation of a country's resources so that the satisfaction of some members cannot be increased by a rearrangement of resources without reducing the satisfaction of other members. A theoretical analysis of the conditions that result in such an optimal situation is provided by Welfare Economics. These conditions may be classified into three groups, viz.,

1. The conditions for achieving an optimum of exchange (distributive efficiency), requiring that the ratio of marginal utilities of any two products be the same for all consumers.
2. The conditions for achieving technical productive efficiency,

requiring that the ratios of marginal productivity be the same in the production of all different commodities produced.

3. The conditions for achieving the optimal direction of production (allocative efficiency), requiring that for any two commodities produced and consumed the marginal rates of substitution and transformation be equal.

These conditions are met in a competitive market economy by virtue of the fact that theoretically only one price exists for all identical commodities and for all identical units of productive factors, respectively, given certain basic assumptions, the most important of which is the assumption that the entrepreneur wishes to maximize profits. Stated in terms of cost and price, the conditions are, first, that price must equal marginal cost and, second, that total cost of the optimum output must be at a minimum. These are also the conditions for profit maximization under competitive conditions.

Theoretical analysis suggests that accounting information plays only a minor role, if any, in the achievement of distributive efficiency. However, in the achievement of technical and allocative efficiency, accounting information appears to be a relevant factor. Theoretically, the enterpriser who wishes to maximize profits under competitive conditions has to equate marginal cost to marginal revenue, or price. To apply this rule in practice, he needs to know price and marginal cost. The former is given by the market, but the latter datum must be generated internally, i.e., by the accounting process. Although marginal cost is not a regular output of the accounting process, management has to rely on the accountant for information relative to

decisions concerning profitable volumes of production. A major problem in the calculation of costs, including marginal costs, is that input prices of productive factors cannot always be taken as "given." The prices obtainable from the market are in some cases "gross," e.g., interest rates may include risk premiums based on conditions that have changed since the acquisition of a loan. In other cases the market prices may be incomplete, e.g., wage rates do not reflect total labor cost. In still other cases prices may have been affected by inaccurate or incomplete prior accounting data. The latter factor is particularly important in estimating a firm's cost of capital. The cost of capital is, among other things, a function of reported net income and financial condition. In order to approximate as nearly as possible the welfare ideal of a uniform input price for identical units of productive agents employed by different producers, the accountant (who wishes to promote the public interest) may have to recognize the factors just enumerated when advising management in regard to production volumes and related matters. The ideal of uniform input prices will also be approached if current market replacement cost is applied in the pricing of cost expirations and the valuation of unallocated costs. Insofar then as accounting can contribute towards the achievement of technical and allocative efficiency in a competitive market economy, it serves a function in directing the market towards the accomplishment of maximum consumer satisfaction, given the state of income distribution. Thus, accounting information may affect the public interest in terms of one of the operational definitions adopted above.

Of the two polar arrangements for the production of a country's economic goods and services - central planning as opposed to private enterprise - the citizens of the United States prefer the latter. Governmental policy to protect and promote the private enterprise system may, therefore, be regarded as an operational definition of the public interest to be related to the functions of accounting in order to determine the relevance of this facet of the public interest to accounting. An examination of the evolution of accounting illustrates its capacity to respond to the needs of the users of accounting information, and to varying environmental conditions. It also illustrates the expanding role of accounting from that of a planning and control tool in the hands of ancient governmental, ecclesiastical, and other public institutions to a business tool; to a management tool; to a governmental tool for the control of the interests of absentee owners and creditors, i.e., auditing; to an organizational information system, successively.

The bulk of the production of goods and services in the United States is undertaken by medium- and large-size organizations, mainly corporations. The efficiency achieved in a major portion of the country's economic production depends to some extent on the efficiency achieved by these corporations which, in turn, depends in part on the accomplishment of accounting as a management tool. Further, organizational participants, motivated by personal objectives to participate in the process of production, need an information system to determine the objectives of fellow participants and the goals of the organization, and also to determine the extent to which their objectives are satisfied

by the organization. The personal objectives of the participants include social, psychological, and economic considerations. Accounting is an effective vehicle for measuring and reporting the economic accomplishments of the organization as they affect the individual participants or groups of participants. The effectiveness with which accounting performs this function contributes to the efficiency of the free enterprise system. Thus, accounting information may also affect the public interest in terms of the second operational definition adopted above.

Since it can be demonstrated that the concept of public interest can be defined operationally and that accounting information may have an impact on the public interest, so defined, it may be concluded that the concept is relevant to accounting theory and practice. The character of a number of generally accepted accounting principles and auditing standards, the contents of the code of professional ethics of the public accounting profession, and the frequency with which the words "public interest" appear in the accounting literature, suggest that the public interest is an implicit environmental accounting postulate. By relating the functions of accounting to the public interest, operationally defined, it is possible to demonstrate that the concept of public interest is relevant to accounting. Thus, weight is added to the thesis that the public interest, as an environmental condition, needs to be recognized as an accounting postulate. Explicit recognition of the postulate accentuates the need to define it in order to ensure that the set of postulates maintains its internal consistency and harmonious relations (19, p. 5). Defining postulates precisely also

enhances the task of deriving principles which are consistent with the postulates.

Two tentative accounting-domain postulates illustrate some possible implications of the particular definition of the concept of public interest adopted in this study. The "market postulate" describes the relevance of accounting information to the functioning of the market mechanism and the "behavioral postulate" states the relevance of accounting information to the functioning of the private enterprise system. These postulates, among others, underlie a "current replacement cost principle" and a "goal-accomplishment reporting principle," respectively. The explicit recognition of a public interest standard in the realm of public accounting practice may accentuate the importance of the independence standard, the auditor's core function as an impartial representative of each of the groups of organizational participants, and the public functions of the auditor as a representative of society.

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BIOGRAPHICAL SKETCH

Abraham Petrus Jacobus Immelman was born February 7, 1931, at Williston, Cape Province, Republic of South Africa. In December, 1946, he was graduated from Van Rhynsdorp High School. In December, 1949, he received the degree of Bachelor of Commerce with majors in Accounting and Business Economics from the University of Stellenbosch. From 1950 to 1953 he served articles of clerkship with the public accounting and auditing firm of Jacobus Potgieter. From 1953 to 1961 he was a partner of the public accountancy firm Potgieter, Immelman and Company. In April, 1961, he was appointed to the staff of the University College of the North, Turfloop, Pietersburg, Transvaal as senior lecturer in Accounting. In September, 1965, he accepted an appointment as senior lecturer in Accounting at the University of Port Elizabeth. In July, 1968, his university granted him leave of absence for a three-year period to pursue graduate study in the United States. Since 1968 he has pursued work at the University of Florida for the degrees Master of Arts with a major in Accounting (1970) and Doctor of Philosophy.

At the University of Florida he taught accounting, was awarded an Earhart Foundation Scholarship and the Haskins and Sells Foundation Assistance Grant for Accounting Teachers and was elected to Beta Alpha Psi.

He is married to the former Christina Wilhelmina Muller, and is the father of five children. He is a member of the Cape and Transvaal Societies of Chartered Accountants and an Associate Member of the American Accounting Association.

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Doctor of Philosophy.

Shih Cheng Yu

Shih Cheng Yu, Chairman
Professor of Accounting

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Doctor of Philosophy.

Ralph H. Blodgett

Ralph H. Blodgett
Professor of Economics

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Doctor of Philosophy.

Milton Z. Kafoglis
Professor of Economics

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Doctor of Philosophy.

Williard E. Stone

Williard E. Stone
Professor of Accounting

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Doctor of Philosophy.

Milford S. Tysseland
Associate Professor of Finance

This dissertation was submitted to the Dean of the College of Business Administration and to the Graduate Council, and was accepted as partial fulfillment of the requirements for the degree of Doctor of Philosophy.

June, 1971

Dean, College of Business Administration

Dean, Graduate School